

MONTHLY REPORTS mid 2003-06

Monthly Reports 2004

USAID MOBIS CONTRACT No. GS-10F-0014K
INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR
MONTHLY STATUS REPORT – JANUARY 2004
PA GOVERNMENT SERVICES, INC.

Activities

- With Peter, Jane, Amila and Elma, and accompanied by Reuf Hadzibegic, participated in the Legal Committee of the House of Peoples as they reviewed the Laws on Transco and ISO. The Committee discussed many potential amendments to these Laws that had been submitted to the Committee, and after much discussion with USAID and its consultants, adopted several that are very controversial. The most controversial ones concern locating the ISO in Mostar, making the Management Boards of the EPs responsible for allocating assets during formation of the companies, and changes to the “cut-off points” between the Transco and the discos and the gencos.
- In preparation for the up-coming meeting of the Legal Committee of the House of Representatives to discuss the two Laws, we have received copies of the proposed amendments that this Committee is considering. They are essentially the same ones as were considered by the Committee of the other House, but with some variation in the cut-off points, depending on whether they were submitted by a member that represents a genco, a disco or the Transco. This meeting was scheduled for January, but has been rescheduled for the first week of February to give the IC more time to lobby against the most damaging amendments.
- With Amila, met with Emir Aganovic to discuss the status of EP BiH in supplying electricity to Aluminij. He reported that total production has increased in January so that they are meeting all of their export contracts and also providing 125 MW to Aluminij, the amount that they have supplied in the past. They are selling this 125 MW to EP HZHB at the tariff price for 110 kV customers, which is 29.7 euro/MW averaged over the year, but is 35.5 euro/MW for the winter months (including January, February and March). For the summer months, the tariff price drops to 23.5 euro/MW.

EP BiH was able to supply 125 MW for the month of January because of high water flow and because they increased generation from their thermal plants by using coal from their reserves. The reserves are so low that they will not be able to continue to draw them down, and so to continue the increased generation from the thermal plants beyond January, the coal mines will need to increase production of coal. The EP has made a request to the Government to have this happen.

- With Amila, met with Sadanovic and Zametica of FMoE. They reported that the MoE was not happy with the new law that OHR has imposed because of the problem of supply of electricity to Aluminij because it is not supportive of the reform of the electricity market, and it creates a Federation market when we are attempting to create a BiH market. Nonetheless, the Federation Government approved the law. In the first Government session after the law was approved, the Government failed to approve the mining of the necessary coal that would allow EP BiH to continue to produce the higher level of power from the thermal plants in February that they did in January. Later, when EP ES offered to sell them coal at a lower price than the 4 KM/Gj regulated price in the Federation, the Government changed their mind and approved the increase in coal production. The Ministry staff complained that the Aluminij problem has overtaken all work on the reform of the electricity sector in the whole of BiH, and they are concerned that the schedules in the Action Plan will not be met. Then, of course, there is the overhanging problem of the review before the Constitutional Court. [This meeting was before the Court gave its ruling.]
- With Amila, met with Dabovic of EP RS to discuss the results of their tender for sale of excess electricity in February, March and April. They continue to have many unexpected outages in the thermal plants – five in one and four in the other in January, for a total of five days outage for each plant. This is caused by the poor repair of these plants and is why they cannot tender for guaranteed supply. He expected more than the three bids they received, and in particular from Montenegro Aluminum, who are paying 30 euro/MW. After our earlier discussion, he decided to make the tender for three months instead of for one year, because of the outages of their thermal plants during the year and the resulting variability of the excess supply. However, there is a lot of pressure coming from the Government to make this an annual tender (no doubt coming from potential buyers looking to lock-in their supplies).

Dabovic has also planned to issue a tender for exchange of electricity from Zone 1 to Zone 2, because when Ugljevic is out of service, EP RS needs to send more electricity into the west (Zone 1) than it can supply from its plants that are working in Zone 2. He has not received approval to issue this tender yet, because in the past only EFT has bid to do this, and last year EP management would not agree to this. Some sort of exchange arrangement is necessary this year because Ugljevic is scheduled to be down for repair for an extended period.

We discussed the possibility of EP RS supplying electricity from their eastern plants, Gatcko and the Tresbinjica HPPs, to EP HZHB instead of selling it via the existing tender into Zone 2. He said that there are some technical problems, but that there are two 220 kV lines running between Trebinje and Mostar that could be used for that purpose. Since there is a good chance that the price in Mostar would be greater than the highest bid they received in Zone 2, he will look at this further, and will contact GD Dakic so that he will not agree on a contract from the highest bidder until this has been evaluated.

- With Amila, met in Trebinje with Radovic, EP RS lawyer, and lawyers from TPP Gacko and TPP Ugljevic. Radovic reported that Dakic had met with the GDs of all of the EP daughter companies in Visegrad to discuss the EP Business Plan and the Action Plan. On Friday, 6 February, Dakic plans to have a meeting in

Banja Luka with the EP Management Board, all GDs and all working Groups at the Agency of Privatization to discuss the transfer of assets prior to corporatization of the daughter companies. They will discuss how the voucher share capital will be allocated, and how to reimburse the shareholders for the vouchers that were given for the companies that will remain in Government ownership.

The Agency for Privatization is preparing to corporatize these daughter companies well ahead of the schedule specified in the Action Plan, and this causes some serious problems. Early corporatization means that the restructuring of the companies will not have taken place, and then after corporatization restructuring will not be able to occur before one year, and even then, it will require 75% shareholder's agreement. However, since the Government will hold no more than 65%, minority shareholders will be able to block restructuring. Even if the EP were to attempt to restructure the companies prior to the early date for corporatization, the Agency says that no change in the structure of these companies can occur until the Government has approved a privatization plan. This places the EP in a Catch-22 situation. We argue that the Government approval of the *Action Plan for Restructuring and Privatization of the Electricity Sector – Part 1*, Restructuring constitutes the required approval of a plan for privatization, since the privatization will occur with the new structure that is accomplished in Part 1. The Agency has not accepted that argument to date.

The situation with Ugljevic II presents another problem with the above position of the Agency for Privatization. Ugljevic II does not exist as a company or as a legal entity of any kind, but when plans for the building of the second unit at Ugljevic were made (1988), expropriation of land was started and liabilities were created. These liabilities have been carried on the books of Ugljevic I, and payments have been made of approximately two million KM. By some monumental foul-up, Ugljevic II was also entered into voucher privatization, and so there are shareholders of this non-entity. The Agency has suggested the answer to this conundrum is to place Ugljevic II into bankruptcy; but how do you declare bankruptcy for something that does not exist? Even if that could be done, lawsuits from the disenfranchised shareholders would be probable. EP RS has suggested that combining Ugljevic II with Ugljevic I would be the cleanest way out of this mess, and then the shareholders of U-II would be combined with those of U-I. However, by the ruling of the Agency as described in the previous paragraph, no restructuring of any of the daughter companies can occur prior to approval of the privatization plan, so the Agency will not allow the only reasonable solution to a mess that they created (issuing vouchers for a non-entity).

The expropriation problem that has caused problems at Ugljevic is due to a fault in the law that only allows the landowners to sue to release an order of expropriation, even if actual expropriation does not occur. In the case of Ugljevic II, no actual expropriation occurred and the landowners have remained on the land and have continued farming and all other activities while still receiving compensation, and there is no mechanism for the company to order an end to it.

TPP Gacko has a different expropriation problem. When land is condemned for the coal that is under it, there is no standard way to determine the value of that land. When land is determined to be "for the good of public use", the landowner

can set a value to that land and the only resolution is through the courts, and the courts have shown that they rule in favor of the landowner in just about every case. It would seem that there should be an arbitration procedure introduced where a standard of land value would be used to decide these disputes. The Gacko lawyers were adamant about not taking it out of the court system, but they have such a terrible record in court cases that one wonders if this is a legal recommendation or a financial one.

On a positive note (well, slightly positive), Radovic reported that the Ministry of Interior is assisting the EP in solving the problem of electricity theft. The EP has submitted 1500 cases of theft to the prosecutor for action, and the MoI is helping where the EP has had security problems with suspected thieves. The EP estimates that 40 million KM is being stolen every year.

- With Amila, met with Andelic, Saraba, GD of HPPs on the Trebisnjica, and Dabovic in Trebinje. Andelic announced that he has scheduled a meeting with EP HZHB to continue the discussions on the water requirements for Capljina. He also reported that there has been no change in the position of HEP on resolving the dispute over power from Dubrovnik HPP, so EP RS has decided to submit it to the court. They have requested the Government to determine who should be the plaintiff. They are requesting damages of 100 million KM.
- With Amila, met with Dabovic of EP RS, who had just met with EP BiH to discuss the possibility of sending electricity to Zone 1 (Mostar) from the EP RS generators in the east. EP RS has determined that they can send 5200 MWh to Zone 1 in February and 7600 MWh in March. In April they won't have any to send because Gacko will be out for repair. Another meeting was scheduled for the next day with Dakic in attendance, but Mikerevic called Dakic to Banja Luka and that meeting had to be cancelled.
- With Amila, met at the Federation MoE with Sadanovic and Zametica. Sadanovic reported on the activities of the Federation Steering Committee on Restructuring, which has members from the unions of the two EPs, and these union members are focusing on privatization and social programs. Their position is that these items must be resolved before any restructuring takes place. It was concluded that their concerns must be discussed with the EPs and the Government, and that the work of restructuring must go on in parallel.
- The ruling of the Constitutional Court creates a problem that could have disastrous consequences. The 60 days period for the Action Plan continuing in effect will have no benefits, because it will take much more time than that to resolve the problem with the Law, and in the meantime no work on restructuring will proceed. Then, after the many months required to change the Law, the Action Plan will not pass in Parliament. The recommendation of the Ministry staff is that OHR impose the Action Plan immediately. The cleanest way for this to happen is for OHR to strike Article 85 from the Federation Law on Electricity. Then there would be no need for Parliament to review the Action Plan, and since it has already been approved by the Government, it would stand as is.

Issues

- The attempt of the Committees in Parliament to add damaging amendments to the Laws on Transco and ISO
- The ruling of the Constitutional Court that Article 85 of the Federation Law on Electricity was not passed with proper procedure, and therefore the Action Plan has not been properly passed by Parliament
- The supply of electricity to Aluminj has not been resolved
- The new law governing the market in the Federation does more harm than good
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- Evaluation of the Buk Bijela Concession Documents confirm that this is a very bad deal for EP RS and the RS Government
- The tenders for billing and collections software of EP RS and EP HZHB are not being coordinated towards obtaining a single system in the country
- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bilece
- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field
- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them

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Activities

- Attended the World Bank meeting that Iftikhar and his team had for their regular quarterly meeting in BiH. Nothing new was revealed in the meeting. The one point of note was that EP HZHB GD Maric said that his position on objecting to the Action Plan had been supported by the Constitutional Court, and that the Federation Government and the USAID consultants should have listened to him before. In the meantime, he reported that his EP is continuing with the restructuring and reform efforts. To contradict that, the Federation MoE stated that there is a deadlock in the Federation and that neither EP HZHB nor the union representative are participating in the Federation Steering Committee for Restructuring. The RS ministry reported that they are proceeding with their Action Plan, but that they are looking for the Federation to resolve their Action Plan dilemma soon so the harmonization of the efforts could continue.
- With Peter and Amila, met with Milovanovic of RS Ministry and Radovic of EP RS to discuss the efforts of the RS Agency on Privatization to corporatize the EP RS daughter companies prior to restructuring, and the implications this will have on restructuring. A problem results because of the existing RS Law on Enterprises which states that no restructuring can take place before one year after corporatization, and then only with a vote of a super-majority of 75% of the shareholders. The former is a problem with the Action Plan schedule and the latter is a problem because minority shareholders own at least 35% of the EP and could block any moves towards restructuring. The EP has proposed changes to the Law to remove these two problems, and Milovanovic agreed that the Ministry would support these changes in the Government. The EP has also proposed changes in the Law on Expropriation because of serious problems the existing Law is causing Gacko and Uglejvic in regard to their coal mines. The Government will also support the EP in these changes.
- Met with Alain Godeau of SEETEC to discuss the progress, or lack thereof in the reform process in BiH. Godeau is disappointed with the lack of progress in the passage of the laws and the recent decision on the Federation Action Plan. He is going to cease all SEETEC TA until these roadblocks are removed. When the two laws are passed and the Federation approves the Action Plan, then he will continue the SEETEC TA. SEETEC has a new project to harmonize the TSO plans for all of the countries in the region.
- In the International Donor's Meeting, DFID announced that further funding for KEMA in their TA to ZEKC would be eliminated unless they see some progress

towards the passage of the ISO Law by the end of February. The EC stated that their only interest is in accession of BiH into the EU, and that they are not interested in the internal restructuring or organization. They support the need for a State Energy Department so that there will be a single organization to work with the EC. The Feasibility Report specifies that the Action Plans for electricity be in operation by June 2004. The WB reported that there is no coherent BiH energy strategy, and in their discussions with the Governments, the RS has said that they don't want a BiH strategy, but only an RS strategy. Howard said that USAID is very disappointed with the recent developments in Parliament on the Laws and with the decision on the Federation Action Plan. USAID sees these as major setbacks to the reform process, and if not corrected, they may cause USAID to withdraw its support for reforms that are going nowhere.

- Met with Aganovic of EP BiH to discuss the recent developments on the negotiations on the supply of electricity to Aluminij. He said that EP BiH will offer the full 125 MW for both February and March at the winter tariff price of 35.5 euro/MWh, and that EP HZHB will supply 80 MW – 30 MW from their own production and 30 MW by import in February, and 60 MW from their own production and 20 MW by import in March.
- In the WB wrap-up meeting, EBRD reported that the Bank is now focusing on a review of non-disbursing loans. The SCADA \$50 million loan for BiH is in this category since the letter agreement was signed in 2000. The Bank could decide to cancel this loan if it is delayed much longer. They will evaluate the results of the Feasibility Report for Phase 1 at the end of March for further input to their decision.
- With Peter and Amila, met with GD Dakic of EP RS. He discussed the new contract that he has just signed with EP BiH to sell their excess electricity into Zone 1 for use in Aluminij that will provide for supplies in February and March at a price of 34.8 to 35.2 euro/MWh. The agreement also provides for EP BiH to supply back up when EP RS has a problem in their supply. Prior to signing this agreement, Dakic had cancelled the tender that had resulted in a high bid of 27 euro/MWh into Zone 2. We congratulated him on making a major economic gain for this EP as well as for making a break-through agreement towards creating a BiH market.

I described our meeting in Banja Luka with his Management Board, the Steering Committee and all of his daughter company GDs that had pointed out the drastic need for implementing accounting reform in the daughter companies and with providing new management that could understand and implement these new systems. The daughter companies have different accounting systems, none of them the same, and some of them hardly exist at all. None of them have cost accounting included. I told Dakic that he has two major problems that, until they are resolved, will result in an unsuccessful attempt at the reform of the EP; namely, lack of technical expertise and lack of management that can even understand what is required.

As for the lack of technical expertise, I told him that this expertise exists in BiH at EP BiH, who have a world-class utility accounting system that Aganovic is implementing in the to-be daughter companies. I suggested that with his new

relationship with Kreso, it would be worth discussing how EP BiH could assist EP RS in obtaining the EP BiH accounting system and in training the staffs of his daughter companies. Dakic said that after an earlier discussion we had had, he has agreed with Kreso to acquire his accounting software package rather than going out on the market for a different one. I commended him for this decision, and pointed out that this software was for a billing and collections system, which is a good package and that this was an excellent decision. However, this new request was not for a software package, but just to install the basic accounting system that is required to operate his company to international standards. The software package that will support this will be supplied by the WB to all of the EPs and their daughter companies later this year. Dakic agreed to meet with Kreso on this subject.

In regards to the second problem that we have seen, that of management's understanding of these problems, I asked him the status of his request to the Government to replace his existing GDs and some of the other top management in the daughter companies. He said that he has had no satisfactory response on this request. He continues to get excuses from the President of his Management Board for delays in doing anything. He said that the problem is that all of the incumbents have political connections. He requested that USAID lobby the Government on this on his behalf.

We told him that in our discussions of the danger of bankruptcy of the TPPs in our meeting in Banja Luka, the Technical Director of Visegrad had said that Visegrad is also in danger of having the same problem. We asked Dakic why that was the case. Are there some hidden liabilities or claims that are about to surface similar to those at Gacko and Uglejvic? He said that he had no knowledge of any problems at Visegrad, and in fact, this is the best performing generating plant in the EP, with performance that far exceeded that of his other HPPs. Peter asked about the inclusion of Marjanovic, the GD of Visegrad, on the new "black list" that the HR had just published. Dakic said that since he heard about this, he has been unable to reach Marjanovic to be able to respond to this, but as is indicated by the performance, he is probably his best manager, and one that he would want to keep if he were cleaning house. Now he is not sure what to do, and asked for our advice. Peter advised that he do nothing until he is requested for some action by his Government.

- With Peter, Jane, Amila and Elma, and accompanied by Reuf Hadzibegic, Lelja Uzicanin and Mark Priestley (part time), participated in the Transport and Communications Committee of the House of Representatives as they reviewed the Laws on Transco and ISO. The Committee discussed many potential amendments to these Laws that had been submitted to the Committee, and after much discussion with USAID and its consultants, adopted two that are similar to the ones passed by the HoP Committee. These concern locating the ISO in Mostar and making the Management Boards of the EPs responsible for allocating assets during formation of the companies instead of the IM as we have proposed.
- With Amila, met with Robert Golub and Miroslav Brumat of Intrade-Energija, a joint venture between a Slovenian company and Intrade that is building some small (less than 5 MW) hydro plants in the EP BiH territory under the auspices of

the renewable energy law. They are interested in further investments in BiH if the climate is right and if the projects have economic viability. They have been considering a bid on Buk Bijela and also a new project that the RS is considering on the lower Vrbas River that comprises two medium size hydro plants – Krupa and Banja Luka Niska, each about 40 MW. We told them of our general concerns about the financial viability of the former, and that the latter two projects that have been on the long term planning in the RS, but were not of immediate interest. They responded that there is current activity on the project to build these two hydro plants, and that a tender for concession is planned to be issued this year. As this was a complete surprise to us, we thanked them for the information and said that we would look into it.

- With Amila and Peter, met with Federation Minister of Energy Zigic and his advisors. Peter told him of the concern of the IC about what is transpiring in the energy sector recently, and that DFID and SEETEC have pulled out their consultants, and that USAID is considering doing the same thing unless the political situation is clarified soon in a positive direction towards the reform of the sector. Zigic responded that he is in a difficult position politically now because of his position in the Aluminij affair, and that he must take careful steps. He says that the Government will evaluate the decision of the Constitutional Court during the next week to decide on one of two ways forward: either to try to eliminate Article 85 of the Law on Electricity so that the Action Plan is the responsibility of the Government only; or to try to pass the Action Plan by the other House in the Parliament. He agrees that the latter is problematic. His assistant, Sadanovic, made a strong plea to get OHR involved in this and to mandate the Action Plan. Peter responded that OHR is not interested in getting involved in the electricity sector, and it is unlikely that they will do this. The response from the Ministry was that they certainly weren't shy about getting involved in December when they proclaimed the new decree on the Federation electricity market.

As to the question of whether we should attempt to work with EP HZHB on the Action Plan as they have invited, he said that GD Maric is under tremendous pressure now, and could not be seen to cross the HDZ because when the EPs are corporatized in March, a new Supervisory Board will be appointed and they will then appoint new management. He said that HDZ is claiming that the ownership of EP HZHB is not by the Entity Government, but by three municipalities in Herzegovina, so the Entity Government has no direct leverage over the EP. I responded that we had reviewed this in detail in 2001 and had concluded at that time that their position on ownership (which was raised then as well) was not supportable, and that the Federation did in fact own the EP. He said that the Ministry would have to look further into this issue, because it is key to resolving the dilemma we are facing.

The big problem that the Ministry and the Government face now is a political one, and so it has to be resolved by lobbying with the different parties. The Government will do what they can, and he urged the IC to lobby also.

- Performed an evaluation of the new hydro project on the Vrbas River that consists of HPP Krupa and HPP Banja Luka-Lower, based on a study that was performed by Energoprojekt of Belgrade in 1999. The projected cost is \$160 million and the predicted annual output is 327 GWh, so the required price of

electricity to allow this project to break even is twice the market price – equally expensive as Buk Bijela.

- With Amila, met with Milovanovic of the RS MoE to discuss the Buk Bijela concession, as requested by the RS Government. We also requested that a discussion of the Vrbas River HPPs' tender because if the tender documents are similar to those of Buk Bijela, this project will also create great liabilities for EP RS and the RS Government. Milovanovic said that the tender documents for the Vrbas HPPs were more recent than those for Buk Bijela, and should be in better shape. However, since the Government didn't note the problems with the Buk Bijela agreements, I doubt that those for the other tender are much better. He agreed to send us the English version of the Vrbas HPPs' tender documents for our review. The tender has been closed for sometime. They say they have received three bids, which would make this a legal tender, although one of them is not a hard bid, but they have used the BiH Umbrella Agreement with Austria as a "bid". They are now negotiating with the high bidder, a combination of: companies: Gradevinar Kraljevo from Belgrade, Energoinvest-Energoinzenjering from Sarajevo and Belgrade and Partizanski Put from the RS. The second bidder is a combination of: Orex Udine from Italy, Hidrotehnika from Belgrade and Energoprojekt-Hidroinzenjering from Belgrade.

With regard to the Buk Bijela tender documents, Milovanovic requested that we supply some suggested replacement language to correct the problems that we had pointed out in the letter to Mikerevic. There is a meeting of the Tender Commission on 22 February, and he needs our input prior to that meeting.

He reported that the amendments to the Law on Enterprises that the EP has requested to counter the problems that will be presented by early corporatization of the daughter companies are in the approval cycle at the Government, and the plan is to have them approved by the Government by the end of February.

Milovanovic said that Minister Bogecevic has signed a letter authorizing the GD of the EP to replace directors of the daughter companies as he considers prudent. When I reported that Dakic told us the Management Board has been delaying this process, Milovanovic said that is because all of the incumbent directors have political connections. He said that he will meet with the Management Board in a few days and will address this problem. I have my doubts that he will have any clout with the Board, and believe that it will take lobbying from the IC to make this happen.

- With Amila, met with the newly constituted Market Working Group for composed of Andelic from EP RS, Radic from EP HZHB and Sadanovic from EP BiH to discuss the market transition during the next two years to achieve a unified BiH market. The discussion was totally focused on the near-term changes that must be made this year and next, and not on some hypothetical market in the future. Next week Barbeau of SEETEC will be in BiH to continue to discuss his idea of a long-term view of the market in BiH around which he intends to write the Market Rules. The WG plans to make it clear that what is needed is the Market Rules for the transition period, not some market five years in the future. The bilateral contract market is the basis for the transition market, and internal contracts are to be developed this year so that the new daughter companies can start to simulate

market operation in the two Entities. Then next year, when the reconstruction of the high voltage network is completed, a single BiH can begin to operate. It was pointed out that for the unified market to operate, it is important to have a single national regulator, so that the consolidation of the three regulators needs to take place during the first half of next year. The hardest part of the transition for this year is the unification of the market in the Federation. This depends on the Action Plan being implemented in its present form. Resolving the impasse on the Action Plan is the number one priority for restructuring the market, as with all of the restructuring of the EPs.

- Attended the Donor's meeting with Peter and Jane, where Lelja Uzicanin reported on the meeting with Minister Doko and on Doko's meeting with the Parliament on their first reading of the two Laws. Doko supported out position on all of the amendments that were added in the Committees, and the SDA and SDP members of Parliament voted to send the Laws back to Committee for further study. We don't know the outcome of this. The IC members who were in attendance agreed to create some material to lobby in favor of keeping the ISO in Sarajevo, using the economic information that has been supplied by ZEKC.

Issues

- The attempt of the Committees in Parliament to add damaging amendments to the Laws on Transco and ISO
- The ruling of the Constitutional Court that Article 85 of the Federation Law on Electricity was not passed with proper procedure, and therefore the Action Plan has not been properly passed by Parliament
- The new law governing the market in the Federation means that the tariffs must be changed this year so that they will cover the costs of production by EP BiH for sales to large industrial customers such as Aluminij
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- Recommendation were made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have not been reviewed, so they probably have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated towards obtaining a single system in the country
- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bileca
- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field

- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them

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Activities

- With Merritt, Amila and Jane, attended a meeting at OHR to discuss the OHR-proposed decree on extending the supply to industrial customers to include the RS. Argued against such a decree on the basis of the technical constraints that now exist between the Entities and within the RS itself which is split between operating in UCTE Zone 1 and Zone 2, with the corresponding need to exchange electricity with another supplier to supply all of its Zone 1 customers. Also, the commercial problems and regulatory problems of having different tariff systems would make such a decree difficult to implement. Finally, EP RS is already selling electricity to the Federation EPs on a commercial basis, which would be the ultimate purpose of the proposed decree, so there is no need for the decree.

We said that we appreciate the involvement of OHR in the reforms of the electricity sector, and that where they are really needed is in resolving the problems with the Federation Action Plan, that is held up by the decision of the Federation Constitutional Court. This problem could easily be resolved if OHR would invalidate Article 85 of the Federation Law on Electricity.

- With Merritt and Amila, met with Director General of EP RS Dakic at his request. He wanted to discuss the tender and the resulting bids and bid evaluation by the committee for large dump trucks and large shovels for the coal yard at Ugljevic. The lowest bidder for the trucks is Belas out of Switzerland for trucks made in Belarus with Cummins engines from England, and for the coal yard shovels is from Kamatsu. They are purchasing this equipment so that they can operate the coalmine at the TPP instead of contracting this work out to third parties. They will have no outside contractors at the coal yard this year. This is a change that we had recommended to them last year. They are doing the same thing at Gacko. He requested that we review the report of the bid review commission.

Dakic also reported that he is in negotiations with Maric of EP HZHB on the sale of excess electricity to EP HZHB during the remainder of the year with the exception of June and July, when they will have no excess. He has offered 33.6 euro/MWh and that is lower than any of the offers that EP HZHB has received for importing electricity to supply Aluminij. EP HZHB must notify Aluminij on 20 March so the EPs must agree on a contract this week.

- With Amila, met with Radovic of EP RS and Milovanovic of RS Ministry of Economy, Energy and Development. We had requested the bidding document and draft agreements for the concession for HPP Krupa and HPP Banja Luka –

lower, and Milovanovic brought the latest revision of the Concession Agreement, but said that there was no draft PPA, but that the bidder would submit his own draft PPA. The only option that the highest bidder made was to acquire all of the electricity from the plants. They also refused to offer an option bid to finance the project for the EP (or the RS Government), as did the bidders for Buk Bijela, because, as Milovanovic stated, they were too high cost. [If they were too high cost to be able to offer financing, how does the Government think they can afford to pay to finance them?] The Concession Commission is working on revising the agreements for Buk Bijela to incorporate my comments and recommendations. This must be completed by 30 March to get it to the bidders in the revised schedule that they have adopted. He said that he would send a copy of the revisions to me for review before they submit it.

Milovanovic said that he has heard from the RS union that EP HZHB has offered to sell 35% of its assets. I told him we had not heard of this. In discussing the restructuring of the daughter companies, Radovic said that HPP Bocac would be in trouble if it had to operate alone because its tariff is not adequate to support its costs. I said that is why we have a milestone in the Action Plan for this year to have the Ministries of Energy rationalize tariffs before the restructuring and corporatization of the daughter/subsidiary companies. Milovanovic said that the RS Ministry would not be permitted by the RS Government Legal Commission to adjust tariffs this year because the Electricity Law says this is the responsibility of the Regulatory Commission. I argued that the Commission would not be capable of doing this during this year, and tariffs need to be addressed to avoid the problem pointed out by Radovic (above). Milovanovic said this would not be possible. This item needs out attention.

We discussed the legal issues of a holding company for the headquarters when the daughter companies are corporatized. As it happens, the Agency for Privatization has not followed the RS Law on Public Enterprises when it privatized the 20% of the daughter companies through vouchers (except for transmission), and therefore, the existing corporate structure is outside the law. This makes creating a holding company very difficult in the manner that we had planned last year when, with the lawyers' assistance, we agreed with the request of the EP to having a holding company during the transition phase of restructuring. After much discussion, it was concluded that we could achieve the same result if we create a Business Association as defined in the Law on Public Enterprises, instead of a Holding Company. In a Business Association, the headquarters and the daughter companies are linked by contractual relationships and not by asset ownership relationships, and that is the result we want to achieve.

- With Amila, met with Dabovic of EP RS to discuss the details of the sale of excess electricity, both to EP HZHB and into Zone 2. Due to higher than normal rainfall, Lake Belica has extra water (approximately 200 GWh more than average) resulting in the EP having more electricity to sell into Zone 1 that was planned. Then, after mid-May when HPP Trebinje goes down for repair, they will have excess water that could be sent down to Capljina because they won't be using it in the HPP. This fact could be used in their negotiations with EP HZHB over the price of electricity for sale into Zone 1 during the year. They will also have excess electricity to sell into Zone 2 because of the high rainfall, and

Dabovic will be discussing this sale with the three bidders who bid from Zone 2 last winter when they cancelled the tender. These include EFT, Atel, NEK and EPS. He said that a tender by Macedonia closed last week with bids from 30 to 35 euro/MW, but doesn't expect to get these prices for such short term notice for sale starting 1 April. He is also looking to purchase some electricity from Zone 2 during June and July when his Gacko and HPP Trebinje are out of service.

- With Merritt and Amila met with Minister Zigic and his deputy Sadonovic at the Federation Ministry of Energy. They had the published ruling of the Constitutional Court on Article 85 of the Electricity Law that was published in the Gazette on 13 March. The ruling also included a minority opinion against the ruling. Zigic said that the Government's position was very poorly argued by the supporters in Parliament, and that the Government was not asked to assist. Zigic also announced that the House of Representatives voted to restrict the amount of strategic enterprises to be privatized to 49%. He said that he tried to argue against this but the HDZ had enough votes to carry it.

Merritt described a strategy that the Embassy recommends to resolve the hold-up of the Action Plan. The Government should propose an amendment to Article 85 of the Electricity Law that includes the House of Peoples. That should be able to be passed by Parliament. Then Parliament will be asked to approve the Action Plan. We would argue with the House of Representatives that they have already approved it, and the House of Peoples would reject it. Then it would be re-submitted to the House of Peoples, who could not continue to block it. Zigic must have been on the same wave length because he said the Government is proceeding in that direction and that he will sign a decree today to amend Article 85.

With regard to the articles in the new about the municipalities in Herzegovina claiming that they own EP HZHB, Zigic said that they proposed that they nominate the Board for the EP, but that Zigic said no, that the Government owned the EP and the Ministry nominated the Board. In his opinion, the munis are negotiating for free electricity because the Government's position on Federation ownership is backed by a strong legal position.

The two Entity Governments had a meeting in Banja Luka on 17 March, at which Zigic proposed that they work together to develop an energy strategy at the BiH level. The RS Government has agreed to this. Also in this meeting, the Federation Minister of Environment requested that the Fatnicko Field Tunnel project be stopped until all environmental and water questions are satisfactorily resolved. Mikerevic responded that the RS has already invested 85 million KM in this project, and they have water studies that show that there is no problem. The Federation requested that a joint study be performed at the BiH level to verify these results before the project is continued. Merritt said that former Ambassador Gelbard had told him that EFT has hired a "very reputable" firm in London to evaluate this problem, and that he would not want to promote a project that would create ethnic tensions. The Federation Government has sent their concerns to the CoM, but the CoM has not responded. The next BiH Parliament will address this and Zigic will be preparing the Parliamentarians. Merritt said that he would also promote this through the US Embassy.

- With Amila, met with Emir Aganovic and Goren Milosevic of EP BiH. The new Assembly of Shareholders of the JSC EP BiH will hold its first meeting on 25 March, and the Board will be elected at that time. This will result in the Federation Government owning 90% of the shares and voucher holders will own the remaining 10%. The Federation Companies Law has no restrictions on this new JSC for transforming it as projected in the Action Plan (as opposed to the RS Law on Public Enterprises, which causes many problems and which we are trying to get amended).

In discussing the activities of restructuring, Emir said that he has been spending a lot of time on the new Business Plan, and is not pleased with the present state of it. First, it does not reflect any restructuring or implementation of the Action Plan. Second, it does not adequately reflect the actual financial status of the different business units that will become separate corporations later this year (according to the schedule of the Action Plan). He is working towards creating accurate internal prices for the business units, and has not received enough cooperation from the EP management to do this. His first priority in restructuring is to determine the status of the headquarters and then to develop a plan for the transfer of personnel from headquarters to the daughter companies. The plan for registration of the new JSC EP BiH is to be registered by the end of April. In passing, he mentioned that EP HZHB is still registered in the court as being owned by the municipalities, and this will be changed when EP HZHB registers as a new JSC.

- With Merritt, Peter and Heather from the Embassy, met with Margit Haberle from the German Embassy, who is newly assigned to Bosnia, and who wanted to discuss the supply of electricity to Aluminij. We had the usual discussion with regard to the interests of the EPs compared to the interest of Aluminij. She said that Aluminij says that they are going to hire a "respected consultant" to perform a detailed analysis of the economic situation of their company to show that they cannot survive unless they have special low rates for electricity. Of course, any analysis of the financial situation of Aluminij will have to be taken with some skepticism because they are not subject to regulation like the EPs are, and therefore, there is no way to check the accuracy of any analysis.
- We received the decree that Federation Minister of Energy Zigic issued to revise Article 85 of the Electricity Law so that it will comply with the ruling of the Constitutional Court. It did not get on the agenda for review by the Government on Thursday, 25 March, and will have wait for another week.
- OHR held a meeting on 25 March with the three EPs (the three GDs were invited, but none attended). The meeting also included members from Aluminij, who said that they require electricity for the remaining nine months at the tariff rate, which averages over these nine months to 27.7 euro/MWh. The meeting was called by OHR to try to get agreement from EP RS to supply their excess electricity during the remainder of the year at these low rates, rather than the market rates that they have offered to EP HZHB. During the meeting, Dresky said that when OHR wrote the decree in December forcing EP BiH to supply their spare electricity to meet the needs of customers within the Federation before they export, he wanted to include all three EPs in the jurisdiction of the decree, but OHR lawyers wouldn't agree. It is clear that OHR is now trying to do just

that, and to force EP RS to supply electricity to EP HZHB for their shortfall in meeting the needs of Aluminij. This would extend the bad policy of supporting the high profitability of EP HZHB at the expenses of the coal miners and the other EPs.

- With Merritt and Amila, met with EP BiH GD Kreso and Mr. Aganovic to discuss the ongoing situation with OHR on the Aluminij electricity supply situation. On the question of ownership of Aluminij, Kreso produced a letter from the President of the Board of Aluminij stating that the ownership was 62% smallholders, 13% foreign (Croatian aluminum company) and 25% Federation. This letter also said that they were not under the Federation laws because they were privatized under cantonal privatization in 1997. Because of the disputed ownership, arbitration was planned to resolve this, but it never occurred. In trying to determine why the Federation Government and OHR are so determined to subsidize Aluminij, Kreso postulated that the HDZ and SDA parties are acting now like they did in the late 1990's when they overtly supported their goals by taking money from Government-owned companies.

Merritt stated that the US Government supported the stance of the EPs in objecting to subsidizing Aluminij at the expense of the EPs. The Embassy has written a letter to OHR to that effect. He said that we support the idea of creating a Federation market during 2004, and then a unified BiH market in 2005 when the technical capability would exist to do that. What this means for this year is to rationalize the existing tariffs so that next year large customers will have the choice of either purchasing electricity on the market or becoming a tariff customer. Therefore, tariffs must be rationalized before mid-year and large customers must request by mid-year whether they wish to be a tariff customer. This will provide the EPs with six months to plan their demand requirements and to line-up supplies to meet this demand. Merritt recommended that the tariff task force that the MoE has formed be tasked with sequestering itself for a week to determine the new cost-based tariffs for all customer levels immediately.

In a discussion of the way forward, Merritt suggested that the three EPs produce their recommendation for a national energy plan that can be the original basis for a document for the new State Ministry of Energy. This is not a new version of the Restructuring and Privatization Action Plan, but a national energy policy plan for the longer term. Kreso said that the three EP GDs were meeting on 30 March, and he would discuss this then. He produced his own six-point plan for the future.

- With Merritt and Amila met with EP BiH GD Kreso, Bjelobuk and Aganovic to discuss the meeting that occurred the day before at EP HZHB with OHR in Mostar. Kreso and Dakic did not attend because Dresky invited himself to the meeting along with representatives from Aluminij. Dresky made his usual plea for cheap electricity for Aluminij, and since there were no decision-makers from two to of the three EPs, nothing was accomplished. Kreso said that Dresky has been prepped on this subject by a German staff member of OHR, Mr. Wendt.
- Prepared a letter for the Embassy to send to Federation Minister of Energy Zigic requesting that the working group on tariff rationalization expedite their efforts so that the new tariffs are approved by the Government and by Parliament by 1

June. This is necessary because the new tariffs need to be published to large customers who may be qualified customers, so that they can make a decision early enough in the year that the EPs can plan for their supplies for next year.

- With Merritt and Amila, met at EP HZHB with GD Maric and his staff and with representatives of the union. Maric complained that all of the effort of himself and his staff has been spent on the Aluminij problem for the past six months. He presented the results of his latest tender for electricity to supply the needs of Aluminij that resulted in the lowest price of 33.6 euro/MWh, the same price that was offered by EP RS. However, EP RS's offer was not for firm supply, and the other offers (the net price of several offers to meet the required capacity) were. Maric said that he did not believe that Aluminij would accept this price, since he planned to pass it straight through. He has given no indication that he would consolidate the price of the imported electricity with that of his hydro plants. If he did this, his average cost of production would be about 25 euro/MWh, which is several euro less than the average production cost of the other two EPs. He continues to request special treatment and subsidies from the other two EPs and the coal miners.

Maric and his staff, supported by the union representatives, then gave their usual complaints about the Action Plan. They stated that they request that there be no restructuring and that the EPs be permitted to operate as they are until a decision is made to privatize. Merritt responded that the Action Plan is the Government's plan, not USAID's, and that we only make recommendations based on the desire and plans of the Government, which has stated that it supports the EU Directives, the Feasibility Report and the Athens MoU towards creating a regional electricity market.

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Issues

- The attempt of the Committees in Parliament to add damaging amendments to the Laws on Transco and ISO
- The Federation Minister of Energy has issued a decree to change Article 85 of the Electricity Law to include the House of Peoples in the approval process for the Action Plan. It has not been placed on the Agenda of the Parliament yet, but we are trying to get it there the first week of April.
- The new law governing the market in the Federation means that the tariffs must be changed by mid-year so that they will cover the costs of production by EP BiH for sales to large industrial customers such as Aluminij
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- Recommendations were made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government

- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated with the other EPs
- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bileca
- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field
- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them
- We are attempting to have the RS Government request that the RS Law on Public Enterprises be amended to reduce the supermajority from 75% to a simple majority required for changes in the structure of public companies so the restructuring of the EP cannot be blocked.
- The Federation House of Representatives has voted to limit the amount of the electric companies that can be privatized to 49%.

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Activities

- With Amila met with Dabovic of EP RS. Because of the excess of water, there is not a good market for the sale of electricity in April. They have agreed to sell the excess that they have (it is only in Zone 2) to EFT for an average of 24 euro/MWh. The amount is 60 MW plus any excess above that that they have. As a result, Ugljevik is off line, and the EP will move forward the repair that has been planned for this summer. I mentioned that Kreso of EP BiH had told us that he was interested in purchasing some of the spare electricity from EP RS during April. Dabovic was not aware of this, but will look into this possibility. If not, then they would hope to start the repairs on Ugljevik early enough so that they could be completed by June so they will have extra sales during June. EP RS is in discussions with EP BiH so that the latter can supply backup to the supplies that EP RS has for sale to Zone 1 so that these sales can be firm.

We asked Dabovic about the details of the water spills during the previous week when Popovo Field was flooded. He said that Lake Bileca was at a level of 399.9 meters above sea level, and that its maximum capacity was 402 meters, but that because of structural considerations, the maximum that is being used for operating is 401 meters. At the maximum level, if there is additional rainfall, then there is uncontrolled spill and everything in the valleys below flood, including the town of Trebinje and the entire Popovo valley. Therefore, they must have a controlled spill at 400 meters and that is what they did. The amount of water this year is at a five-year high, and this is the normal result when this level is reached.

- With Merritt and Amila, met with Director General of EP BiH Enver Kreso. To be prepared for the new tariffs that the Federation must determine prior to mid-year, Kreso has instructed his EP to have a draft of the suggested rates by the end of this week. These new rates will include:
 - A realistic value for the assets values of all of the business units (presently TPP Kakanj and ED Travnik and Zenica have asset values that are unrealistically high so that their depreciation rates are too high);
 - Customers will be designated by voltage level only – 110 kV, 35 kV, 10 kV and 0.4 kV – and the cost of service for these voltage levels will be determined. This will resolve the very high level of tariffs now being charged to small business and commercial customers who are served by the 0.4 kV lines.

- The seasonal periods of summer and winter will be re-evaluated to determine if the timing and the difference in rates between these two periods are treated properly. Likewise, the different rates between day and night will be re-evaluated.
- Kreso has suggested creating a new rate category for sales to EPs within BiH so that no party is penalized. This is an attempt to correct the problem that exists because EP HZHB is passing through to their large customers the cost of all purchased electricity rather than averaging it with their low-cost hydro production for all of their customers. Because of the new law that OHR has imposed, this means that EP BiH and the coal miners are subsidizing the high profits of EP HZHB. I pointed out that this proposed new tariff rate was a superficial fix and would not get to the real cause of the problem. The real problem can only be fixed by the Ministry of Energy forcing EP HZHB to roll the purchased power rates in with their generated power for all of their customers. Kreso said that the Ministry would have a political problem in doing this, and that this would be up to the regulator. We pointed out that the Federation regulator would not be operational this year, and so the Ministry would have to take this decision. It will not be any more difficult to take this decision than it will be to get agreement between the two EPs on a new tariff rate. Either way, EP HZHB is going to have to give up some of its unfair profits that have been received during the past three years.

Kreso also spoke about the disagreement EP BiH has with HEP over the payoff of a note that they have for some work performed by HEP in the past. HEP has a suit against EP BiH, and EP BiH has made an offer to supply electricity for five years to pay off the debt. However, HEP disputes the amount of this debt.

EP BiH has a dispute with EP HZHB over land that was originally part of HPP Mostar that was owned 50/50 by the two EPs. The land on one side of the river was leased by the Mayor of Mostar to the Spanish contingent of SFOR, for which EP BiH received rent. When this lease was over, EP HZHB assumed ownership of this land. [This would seem to be a problem only if the ownership of EP HZHB were in dispute. Now that the ownership problem seems to be resolved, I don't see what the problem here is.]

The Spanish are offering to perform a study of the renewable energy potential in the Federation. This agreement is on paper and is ready for the signatures of the Spanish Ambassador and Minister Zigic, but with EP HZHB managing this program and controlling the data and the confidentiality of the results. This study is worth some 300,000 KM and is to determine the potential sites for wind generators in the Federation. If it is for the whole Federation, why is EP HZHB managing it and why is the data confidential?

- With Merritt and Amila, met with Minister Zigic of Federation MoE and his two advisors, Sadonovic and Zametica. With regard to the electricity supply to Aluminij, Zigic said that Maric offered a three-month contract and a nine-month contract. He said that Dresky requested that all prices be at the average tariff rate of 29.7 and that the supplies from EP RS be at the same price. Zigic said that he will not give in to any pressures from OHR to reduce the price. He also

said that he requested that PM Hadzipasic not get involved in this negotiation, and that the PM agreed.

Zigic said that he supports the schedule for having the new tariff system completed by 30 April and will send a decree to that effect. This schedule will allow the new tariff system to be in effect by 30 June. The Tariff Commission that he has appointed has met a couple of times already. They are revising the Tariff System, not just the tariff rates. It was agreed that Article 16 should be eliminated in the revised system, and that all customer categories should be based on the cost of service to that category.

Zigic informed that the Government has approved the change in Article 85 according to his decree, and it is ready to be sent to Parliament. However, the next session in which it could be on the agenda is towards the end of April, and that there is no way that it will finally be passed before the end of April. If that does not happen, then the Action Plan will be dead. He also said that the HDZ is preparing other amendments to the Law, one of which states that restructuring be accomplished within the EPs.

We concluded that the only way to save the Action Plan as it is written will be to re-write Article 85 to state that the Action Plan on restructuring does not need the approval of Parliament, and that the Action Plan on privatization will be approved by both houses of Parliament; and then to have OHR impose this new amendment. The argument to OHR for imposing this amendment is that without the Action Plan, there is no unified Federation market, and the Law that OHR imposed on 31 December will not be able to be implemented. Merritt agreed that he would take the steps to achieve US Embassy agreement on this approach.

- Prepared a strategy paper for the passage of the Action Plan as proposed in the meeting with Minister Zigic. Then Merritt talked to Chever who said that OHR is unlikely to impose anything, so we had better prepare a backup strategy for the adoption of the Action Plan. This backup strategy was prepared, with all of the caveats that go along with it, and it is not a pretty picture. If we have to go to the Parliament, and other amendments are added to the Law, then the reform process may be totally blocked, or at least delayed by so much that we cannot form the Single Transmission Company or the ISO. If this happens, BiH will not have satisfied the Feasibility Report or the Athens MoU, will have violated the EU Directives and will not have either a national market or a unified Federation market.
- With Merritt and Amila met with EP RS GD Dakic. The primary topic on his mind was the form of the Headquarters Office after corporatization. The results of the last meeting we had with his lawyer Radovic resulted in a recommendation that the relationship between HQ and the daughter companies after corporatization would be in the form of a Business Association rather than an asset owning corporation. The relationship of a Business Association is governed by contract rather than by direct management. Dakic said that he has had experience with these kinds of Associations and that they do not work well in the business culture of BiH. He recommended that the relationship be as a Holding Company, and he gave us a draft decree that would accomplish this. Our earlier thoughts on this type of HQ organization were that it would be harder to dissolve when the

daughter companies are privatized and we want to eliminate the HQ. However, in light of the weakness of the daughter companies, we said that we will review the proposal and respond to him in a few days.

With regard to the proposal for EP RS to sell electricity to EP HZHB for sale to Aluminij, Dakic said that Dreski had tried to get him to sell it at the average tariff rate of 29.7 euro/MWh rather than the market rate of 33.6 euro/MWh. He did not agree to that. He said that EP HZHB has kept him on hold for three weeks on his offer to sell at 33.6. Kreso has been talking about providing backup to EP RS so they can offer firm power in Zone 1, but no contracts have been offered. It was agreed that this needs to be done quickly.

- With Merritt, Heather and Amila, met at EP BiH with GD Kreso, Aganovic and Spahic. On the subject of supply of electricity to Aluminij, Kreso met with Hayes of OHR and Kreso told Hayes that he could not accept that he sell electricity at 29.7 euro/MWh because it is below the cost of production, and if he did that for three months, EP BiH would lose one million KM, and Kreso would be liable for making a bad business decision for the EP. He said that Maric has made an offer at 33.6 euro/MWh to Aluminij for the remainder of the year that consists of the surplus from EP RS that is non-firm backed up by reserves from EP BiH to make it firm, with any costs incurred by EP BiH to be paid by EP RS. He will offer this to Aluminij with the provision that if the market price drops between now and the end of the year, the price to Aluminij would be adjusted downward to reflect this drop. Zigic has agreed that no costs for transportation need be added. Aluminij has not accepted this offer yet, so the problem is not resolved.

In discussing the tariff work that EP BiH is performing for the Tariff Working Group, he said that they will have a proposal to make to the WG when it next meets. The WG plans to spend four days full-time at the EP BiH Educational Center in Zenica, and if that is not enough, they will spend more time at Neum. The ground rules that EP BiH is working on for the new tariff system include the following:

1. Assure that the business conditions (i.e., profitability) of the two EPs are the same
2. Have no customer class pay less than the cost to supply
3. Rationalize the tariffs of the 0.4 KV customers so that both residential and small businesses and commercial customers pay the cost of supply
4. Change the relationship between summer and winter rates to better reflect the current demand profiles
5. Develop an inter-company tariff to assure that condition No.1 is met
6. Adjust the depreciation rates of the EP BiH assets so they are more consistent with the actual values

The total affect of these changes will be to increase revenues to EP BiH by 3 to 5%. They plan to have their analysis completed prior to the next meeting of the

WG, with the projected financial results for both EPs. The analysis to-date show the following changes:

1. Tariffs for 110 KV customers will increase by 10%
2. Tariffs for 35 KV customers will increase by 15%
3. Tariffs for 10 KV customers will decrease by 15%
4. Tariffs for 0.4 KV small businesses will decrease by 20%
5. Household tariffs will increase by 22%
6. The ratio of winter-to-summer rates will change from 1.5-to-1 to 1.3-to-1.

It was agreed that a large public relations campaign must be undertaken to sell the benefits of these changes, and that the EPs must take the lead in this. Kreso argued that the average monthly household electricity bill now is 28 KM and that the increase would only add 6.2 KM to this. The big winners will be the small businesses, and these are the most important for the creation of new jobs that will do the most to increase the economic capability of the country.

Kreso said that he and Dakic of EP RS are in discussions on combining their coal reserves so that less reserves are needed, and this will result in significant savings in the cost of coal for their reserve capacity. In response to Merritt's statement that the coal mine restructuring needs to be done in parallel with the electricity restructuring, Kreso said that legislation is required for the coal mines because all miners are treated equally, and in reality surface mines are worked by laborers, not miners who work the deep mines. This will make a large difference in the cost of reducing the labor force in the mines.

EP BiH will propose these changes to the WG and open the discussion with the other members. The change that will cause the profitability of both EPs to be rationalized will not be popular with EP HZHB because they have been selling their low-cost hydro production to their high tariff customers and passing through the high-cost purchased energy to their low-tariff customers. This has resulted in an extremely high profitability, which has allowed them to have the highest cost of operation as well as to be able to build the high-cost Pec Mlini hydro plant. Finally, the Minister of Energy will have to arbitrate the difference between these two points of view.

- With Amila, met with Radovic of EP RS to discuss their proposal for the organizational structure of the EP Headquarters after corporatization. In the Action Plan we had proposed a relationship between HQ and the daughter companies that would be governed by a contract. This type of relationship is that of a Business Association, and GD Dakic is not happy with that because he has had bad experience with it in the past. He has requested that the HQ corporatized as I JSC and be related the daughter companies through a mixed holding company as defined in the RS Law on Enterprises. We discussed all of the implications of this in terms of the restructuring and the other actions proposed in the Action Plan. Radovic agreed to make some revisions to the

proposed decree that the EP plans to submit to the Government that will better define the transition period up to privatization and that will define the end-situation for the HQ function.

One of the things that must be resolved before the corporatization of EP RS is how the new HQ Building will be treated. Its assets are now jointly held by the HQ and the generation subsidiaries. I recommended that this be treated separately as a non-core business and privatized on its own. The EP has spent between 7 and 8 million KM on this building, and there is no potential buyer at that price. I said that it will be sold at market price, and the book value may have to be written down on the books of the owning companies.

Before the companies can be corporatized, the assets and liabilities of all of the companies must be determined. He said that they are well advanced in this job, except for Ugljevik 2, which is such a mess that nobody wants to touch it. The Privatization Agency has valued it at a greater value than Ugljevik 1, but it was never registered as a company and has no employees. The EP has recommended that the Government hire an independent consultant to untangle this mess, so that it can be put into bankruptcy, although it is not clear how you put a non-entity into bankruptcy.

Radovic said that the four laws that the EP has recommended that the Government initiate changes to be made and which the Government promised to do have had no action taken on them. Dakic has a meeting with PM Mikerevic on 20 April to discuss a list of concerns about the electricity sector and the EP, and these changes to the laws are on the agenda, as is the resolution of Ugljevik 2. Another item for discussion is how to treat the money that has been spent preparing the Buk Bijela Project, which amounts to 50 to 60 million KM.

We had mentioned the bad situation that the Concession Agreement on the Vrbas River hydro plants could cause the EP to Dakic by phone, and he requested that we discuss this subject with Radovic. The latter knew nothing about this project, as he said that it totally a Government project. I pointed out that the project and the concession could not be implemented unless the EP signed a power purchase agreement, and that the terms of this PPA would put the EP into a terrible economic position. Radovic said that he would report this to Dakic, but that he didn't see how the EP could do this because the plans are to disband the EP in a year or two.

- Prepared discussion papers on the RS Government's planned concessions and on the planned projects that EP HZHB is undertaking. USAID sent these to OHR in preparation for their meeting with EFT at which the concession for Buk Bijela is planned to be discussed. Both papers show the bad economics of these projects and the liabilities that the EPs and the Government will be undertaking by proceeding with them.
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In a side meeting with Dabovic concerning the purchase of electricity from either Buk Bijela or from the Vrbas River HPPs for which a Concession Contract is being negotiated with the winning bidder, he said that the EP could not purchase electricity from these new plants for their own use, but would have to purchase it for sale as a trader. Therefore, he questioned how the EP could pay a price that is higher than the market price and then sell into the market. He also raised the question that we have raised on many occasions of who would be the purchaser since the EP would cease to exist before these plants would be completed.

In another side meeting with GD Dakic, he said that he is being pressurized by Hayes to reduce his offer price for electricity to EP HZHB for the last six months of the year. He said that he has not agreed to any reduction, but might if he could receive a "trade". It appeared that he was referring to a trade from Aluminij, although he didn't state that specifically. If so, he is proposing the old barter game and he should be discouraged against that. We will pursue this with him when he meets with us the first week of May in Sarajevo.

Issues

- The Federation Minister of Energy has issued a decree to change Article 85 of the Electricity Law to include the House of Peoples in the approval process for the Action Plan. It has been placed of the Agenda of the Parliament for the first week of May.
- The new law governing the market in the Federation means that the tariffs must be changed by mid- year so that they will cover the costs of production by EP BiH for sales to large industrial customers such as Aluminij
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- After our recommendation were made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government, they removed the offending documents from the required bid documents so that they are now not subject to public scrutiny
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated with the other EPs

- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bileca
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- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them
- We are attempting to have the RS Government request that the RS Law on Public Enterprises be amended to reduce the supermajority from 75% to a simple majority required for changes in the structure of public companies so the restructuring of the EP cannot be blocked.
- The Federation House of Representatives has voted to limit the amount of the electric companies that can be privatized to 49%.

USAID MOBIS CONTRACT No. GS-10F-0014K
INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR
MONTHLY STATUS REPORT – MAY/JUNE 2004
PA GOVERNMENT SERVICES, INC.

Activities

- With Merritt and Amila met with GD Dakic of EP RS. I expressed my concerns about the liabilities that EP RS would be taking on if the proposed concession agreements for Buk Bijela and the Vrbas River HPPs go ahead. He said that he had not agreed to any liabilities on either of these proposed projects, and that he was not aware of the agreements would involve the EP to purchase electricity from them at a high price.

Dakic said that the RS Government has requested that the EP supply electricity to Alumina Company in Zvornik at a 25% reduction in price. He said that he has refused to do that for a customer who is a non-payer. He said that he countered with the offer to take some payments in products for some of the industrial companies in the RS who want discounts. We told him that USAID and OHR are against the use of barter to settle accounts because of the lack of transparency in these kinds of transactions, which provide opportunities for fraud or at least give the presumption of fraud. He said that PM Mikerevic also offered Government assistance to some of the industries in the RS if he would lower the price of electricity to Alumina. We said that this would be a cross subsidy of electricity prices, and that it would be better if the Government would subsidize Alumina directly without getting the EP involved.

Dakic is under great pressure to appoint new people that are recommended by the Government to the replacement positions of the GDs of the daughter companies. He asked if we could assist in his attempt to make those decisions on the basis of his evaluation of candidates, rather than the political appointees of the Government. Merritt said that he would request a meeting with the PM and the Minister of Energy to discuss this issue as well as other important issues that are on Dakic's agenda.

- Review the draft of the new Tariff System that has been proposed by the Tariff Expert Group appointed by Minister Zigic to develop the methodology and proposed interim tariff values for implementation this year, prior to the Regulators being able to do this. The draft document was very poorly written to the point of not being understandable. I made some comments and sent it back with some questions, comments and a request that it be re-drafted before we discuss its contents. We need to have this new Tariff System approved by the Government before the summer holidays so that it can be introduced in September for implementation at the beginning of 2004. There is still a question of whether the Government or the Regulator(s) will approve these interim tariffs, but with the

time constraint and the lack of capability of the Regulators, it would appear that approval by the Ministry of Energy and the Government would be most expeditious.

- In Washington, DC, met with Bob Archer and some of his staff on a conference call to Merritt and Peter of USAID in Sarajevo and Jim Schmidt of Hunton and Williams in Richmond. The purpose of the call was to discuss the electricity market in Bosnia in relation to the markets in the other SEE countries and the SMD of the EU for SEE. Schmidt, who is looking at the markets in several SEE countries as well as the SMD, and the USAID DC staff, confirmed our position that the BiH market that we are pursuing is a most reasonable market given the conditions that exist in BiH, and that it is not inconsistent with the SEE SMD.

This group also addressed the differences that SEETEC has with our market design, and it was concluded that the SEETEC proposals were not in line with what the BiH systems could achieve at this time. Archer said that Ichord would discuss this in Athens next week, and propose a meeting in Brussels with USAID and SEETEC to resolve any disagreements that still existed.

- Prepared a strategy paper for the passage of the Action Plan as proposed in the meeting with Minister Zigic. Then Merritt talked to Chever who said that OHR is unlikely to impose anything, so we had better prepare a backup strategy for the adoption of the Action Plan. This backup strategy was prepared, with all of the caveats that go along with it, and it is not a pretty picture. If we have to go to the Parliament, and other amendments are added to the Law, then the reform process may be totally blocked, or at least delayed by so much that we cannot form the Single Transmission Company or the ISO. If this happens, BiH will not have satisfied the Feasibility Report or the Athens MoU, will have violated the EU Directives and will not have either a national market or a unified Federation market.
- With Merritt and Amila met with EP RS GD Dakic. The primary topic on his mind was the form of the Headquarters Office after corporatization. The results of the last meeting we had with his lawyer Radovic resulted in a recommendation that the relationship between HQ and the daughter companies after corporatization would be in the form of a Business Association rather than an asset owning corporation. The relationship of a Business Association is governed by contract rather than by direct management. Dakic said that he has had experience with these kinds of Associations and that they do not work well in the business culture of BiH. He recommended that the relationship be as a Holding Company, and he gave us a draft decree that would accomplish this. Our earlier thoughts on this type of HQ organization were that it would be harder to dissolve when the daughter companies are privatized and we want to eliminate the HQ. However, in light of the weakness of the daughter companies, we said that we will review the proposal and respond to him in a few days.

With regard to the proposal for EP RS to sell electricity to EP HZHB for sale to Aluminij, Dakic said that Dreski had tried to get him to sell it at the average tariff rate of 29.7 euro/MWh rather than the market rate of 33.6 euro/MWh. He did not agree to that. He said that EP HZHB has kept him on hold for three weeks on his offer to sell at 33.6. Kreso has been talking about providing backup to EP RS so

they can offer firm power in Zone 1, but no contracts have been offered. It was agreed that this needs to be done quickly.

- With Merritt, Heather and Amila, met at EP BiH with GD Kreso, Aganovic and Spahic. On the subject of supply of electricity to Aluminij, Kreso met with Hayes of OHR and Kreso told Hayes that he could not accept that he sell electricity at 29.7 euro/MWh because it is below the cost of production, and if he did that for three months, EP BiH would lose one million KM, and Kreso would be liable for making a bad business decision for the EP. He said that Maric has made an offer at 33.6 euro/MWh to Aluminij for the remainder of the year that consists of the surplus from EP RS that is non-firm backed up by reserves from EP BiH to make it firm, with any costs incurred by EP BiH to be paid by EP RS. He will offer this to Aluminij with the provision that if the market price drops between now and the end of the year, the price to Aluminij would be adjusted downward to reflect this drop. Zigic has agreed that no costs for transportation need be added. Aluminij has not accepted this offer yet, so the problem is not resolved.

In discussing the tariff work that EP BiH is performing for the Tariff Working Group, he said that they will have a proposal to make to the WG when it next meets. The WG plans to spend four days full-time at the EP BiH Educational Center in Zenica, and if that is not enough, they will spend more time at Neum. The ground rules that EP BiH is working on for the new tariff system include the following:

1. Assure that the business conditions (i.e., profitability) of the two EPs are the same
2. Have no customer class pay less than the cost to supply
3. Rationalize the tariffs of the 0.4 KV customers so that both residential and small businesses and commercial customers pay the cost of supply
4. Change the relationship between summer and winter rates to better reflect the current demand profiles
5. Develop an inter-company tariff to assure that condition No.1 is met
6. Adjust the depreciation rates of the EP BiH assets so they are more consistent with the actual values

The total affect of these changes will be to increase revenues to EP BiH by 3 to 5%. They plan to have their analysis completed prior to the next meeting of the WG, with the projected financial results for both EPs. The analysis to-date show the following changes:

1. Tariffs for 110 KV customers will increase by 10%
2. Tariffs for 35 KV customers will increase by 15%
3. Tariffs for 10 KV customers will decrease by 15%

4. Tariffs for 0.4 KV small businesses will decrease by 20%
5. Household tariffs will increase by 22%
6. The ratio of winter-to-summer rates will change from 1.5-to-1 to 1.3-to-1.

It was agreed that a large public relations campaign must be undertaken to sell the benefits of these changes, and that the EPs must take the lead in this. Kreso argued that the average monthly household electricity bill now is 28 KM and that the increase would only add 6.2 KM to this. The big winners will be the small businesses, and these are the most important for the creation of new jobs that will do the most to increase the economic capability of the country.

Kreso said that he and Dakic of EP RS are in discussions on combining their coal reserves so that less reserves are needed, and this will result in significant savings in the cost of coal for their reserve capacity. In response to Merritt's statement that the coal mine restructuring needs to be done in parallel with the electricity restructuring, Kreso said that legislation is required for the coal mines because all miners are treated equally, and in reality surface mines are worked by laborers, not miners who work the deep mines. This will make a large difference in the cost of reducing the labor force in the mines.

EP BiH will propose these changes to the WG and open the discussion with the other members. The change that will cause the profitability of both EPs to be rationalized will not be popular with EP HZHB because they have been selling their low-cost hydro production to their high tariff customers and passing through the high-cost purchased energy to their low-tariff customers. This has resulted in an extremely high profitability, which has allowed them to have the highest cost of operation as well as to be able to build the high-cost Pec Mlini hydro plant. Finally, the Minister of Energy will have to arbitrate the difference between these two points of view.

- With Amila, met with Radovic of EP RS to discuss their proposal for the organizational structure of the EP Headquarters after corporatization. In the Action Plan we had proposed a relationship between HQ and the daughter companies that would be governed by a contract. This type of relationship is that of a Business Association, and GD Dakic is not happy with that because he has had bad experience with it in the past. He has requested that the HQ corporatized as I JSC and be related the daughter companies through a mixed holding company as defined in the RS Law on Enterprises. We discussed all of the implications of this in terms of the restructuring and the other actions proposed in the Action Plan. Radovic agreed to make some revisions to the proposed decree that the EP plans to submit to the Government that will better define the transition period up to privatization and that will define the end-situation for the HQ function.

One of the things that must be resolved before the corporatization of EP RS is how the new HQ Building will be treated. Its assets are now jointly held by the HQ and the generation subsidiaries. I recommended that this be treated separately as a non-core business and privatized on its own. The EP has spent between 7 and 8 million KM on this building, and there is no potential buyer at that price. I

said that it will be sold at market price, and the book value may have to be written down on the books of the owning companies.

Before the companies can be corporatized, the assets and liabilities of all of the companies must be determined. He said that they are well advanced in this job, except for Ugljevik 2, which is such a mess that nobody wants to touch it. The Privatization Agency has valued it at a greater value than Ugljevik 1, but it was never registered as a company and has no employees. The EP has recommended that the Government hire an independent consultant to untangle this mess, so that it can be put into bankruptcy, although it is not clear how you put a non-entity into bankruptcy.

Radovic said that the four laws that the EP has recommended that the Government initiate changes to be made and which the Government promised to do have had no action taken on them. Dakic has a meeting with PM Mikerevic on 20 April to discuss a list of concerns about the electricity sector and the EP, and these changes to the laws are on the agenda, as is the resolution of Ugljevik 2. Another item for discussion is how to treat the money that has been spent preparing the Buk Bijela Project, which amounts to 50 to 60 million KM.

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- With Merritt and Amila, met with Federation MoE Zigic and his assistant Sadanovic. Zigic said that the Government supports the version of the new Article 85 that requires both Houses of Parliament to approve Part I of the Action Plan. This was the version that the House of Peoples passed. We had favored the version that the House of Representatives passed that did not require either House to approve Part I of the Action Plan. It seems like the Government made their decision because it will be less controversial in obtaining final approval by Parliament. To rectify the two different versions, the Government is pressing to get the approval on the agenda of the House of Representatives for 29 June. Zigic said that this should pass, and then the Action Plan would be submitted to the House of Peoples for approval in July. Because it is not legislation, it will only require a simple majority to pass, and he said the HDZ does not have enough votes to block it. The bad news is that even if the Action Plan gets approved in July, nothing will start to happen before September, which means a further three-month delay.

Zigic said that he met with EP BiH to discuss the draft report of the Tariff Expert Group, and told Kreso that it will not be possible to increase the tariffs in the amount recommended in their report. I told him that there are two parts to the report, and the increase proposed is not as important to address now as the Tariff System that they recommend. There are several areas in this proposed System that need more work before they are approved. I recommended that we work together to improve this part of the report, and that he will have the final decision on the actual values of the new tariffs. I told him that the most important tariff to have increased at this time is the one for high voltage customers because of the OHR Decree that requires EP BiH to sell their electricity to Aluminij, and the existing tariff rates for this customer class do not cover the costs of the TPPs.

Another area that needs to be changed, that Zigic also mentioned is the tariff for exchange of electricity between the EPs in the Federation. Zigic requested that I prepare a list of recommended changes to the Tariff System that he will send to the EPs and then he will call a meeting with the EPs to discuss my recommendations along with the recommendations of the Expert Group.

Merritt discussed some of the problems that we are having with the FERC Commissioners. Some of their actions are not proper for Commissioners, and it must improve or some changes will have to be made. Whichever one of these

occurs, it will mean a delay in FERC obtaining the capability to evaluate and approve tariffs. For this reason, it is not reasonable to wait for FERC to approve the Tariff System or the tariff rates that must be approved this summer for implementation next year. The Ministry of Energy, Mining and Industry must take this responsibility.

- Attended the EU Workshop discussing the needs of the donors to support the reforms in the energy sector that are needed to support the Athens MoU. The meeting had been planned with the assistance of Reuf Hadzibegic, and was to be based on his National Action Plan. However, the Plan is so poorly written and is not a plan at all, but an incomplete and incorrect status report, so the meeting did not accomplish much. We commented that the National Action Plan should be a way forward and should be based on the Entity Action Plans. The problem remains, however, that Reuf will not/cannot produce such a plan himself, and he has no one to assist him.

Issues

- The most optimistic scenario for approval of the Federation Action Plan will result in a three-month delay.
- The new law governing the market in the Federation means that the tariffs must be changed by mid- year so that they will cover the costs of production by EP BiH for sales to large industrial customers such as Aluminij
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- After our recommendation were made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government, they removed the offending documents from the required bid documents so that they are now not subject to public scrutiny
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
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Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.

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Activities

- With Merritt and Amila met with Federation Minister of Energy Zigic and his assistant Sadanovic. Zigic reported that the Federation House of Representatives is scheduled to meet on 29 June to adopt the version of Article 85 that the House of Peoples passed, which is the version that says both Houses have to approve the Action Plan. If the House of Representatives passes this version, then the Action Plan would be scheduled for approval in the House of Peoples during their session in July. Zigic said that he doesn't see a problem in getting it approved by the House of Peoples because it only requires a simple majority, so the HDZ cannot block it.

With regard to the new Tariff System proposed by the Expert Group, Zigic said that he had met with EP BiH and told Kreso that the increases in tariffs that were proposed by the WG were not possible at this time. We said that it is important to pass a new Tariff System now, even if the rates are not increased at this time, because the OHR Law that was passed last December cannot work with the old Tariff System. However, the draft that was proposed by the WG has some problems that should be corrected before it is passed. Merritt described some problems with the FERC getting established so that they would not be available to approve the new Tariff System. As a result the Ministry of Energy would have to issue a degree approving it. To address our concerns about the draft Tariff System, Zigic said that he would call a meeting of the Ministry and the EPs to discuss it. Merritt said that we would issue a discussion paper that would set out our concerns with the draft of the WG.

- Attended a Workshop that the EC planned with the assistance of Reuf Hadzibegic to discuss the reforms and the ongoing needs for assistance from the donor community. In a poorly planned and executed meeting, not much was decided, except that the National Action Plan that Reuf presented was not an action plan at all, but a status report, and not a very accurate one at that. It was recommended that a National Action Plan should be created, based on the Entity Action Plans and the other plans that are ongoing.

In a regular Donor's Meeting, no EC representative was present. The organization of the EC was discussed, and the fact that DGTREN in Brussels is not tied into the local office was pointed out. CIDA said that they were considering supporting a head of the new State Energy Department for up to one year when the EC's support for that position becomes available. I agreed to write the TOR for this job for CIDA. SEETEC said that they were considering support

for the TA to assist Transco and the ISO to develop business plans. This would be at the expense of their present scope of work.

- I met with Reuf to discuss comments that I had made on the National Action Plan. My comments were mostly directed towards correcting some errors that he had with regard to the market development (which were written for him by Godeau), and to removed references to regional cooperation with Slovenia and Croatia. There has been no work on this, and only a single meeting where EP Slovenia made a presentation of their System.
- With Amila met with GD Dakic and Dabovic from EP RS. With regard to the proposal for EP RS to sell electricity to EP HZHB for sale to Aluminij, Dakic said that he has been waiting for the proposal from EP BiH to offer back up to EP RS so that they can offer guaranteed supply. He had just received an offer, but EP BiH cannot supply the required power for August or for the last three months of the year. He said that they are asking for 1.05:1 in energy exchange for this service. Since it appears that this is the beginning of a negotiation, he will meet with them again to try to reach an agreement.
- EP RS could not reach a satisfactory agreement with EP BiH on the supply of back-up power, so they concluded an agreement with HEP to provide that back up. EP RS then agreed to sell to EP HZHB the amount that they had requested in their bid as firm supply, with the price to EP RS of 29.2 euros/MWh. The bid by EP HZHB was 31.5 euros/MWh, so HEP will be paid the difference for supplying the guarantee of firm power supply.
- Met with Alain Godeau of SEETEC to discuss the future market in BiH and its relationship to the regional market(s). He repeated the proposal that he had made to MOFTER in May that BiH should be part of the sub-regional market created with Slovenia and Croatia that would use the ISO of Slovenia as the control center. I pointed out that this could not be considered the BiH strategy with just one meeting, but that it could be an option that could be considered in the future. However, my view remains that even if this is desirable sometime in the future, we need to develop a transition market that is capable of operating the system on day-one, which will be sometime early next year. He then made a further proposal that Slovenia could operate a day-ahead and balancing market immediately for BiH, so that there would be no need for a transition period with a less sophisticated market in BiH. I told him that the BiH system is not capable of doing that now because of the lack of proper metering and controls on its thermal power plants. He recommended that BiH should continue operating as it is until it can join the day-ahead and balancing market that Slovenia is operating, rather than begin to operate a less sophisticated market next year. My response was that the time period that he is suggesting is of the order of at least five years, not the few months that he assumes, and it would not be practical or politically acceptable to wait for five years to introduce some kind of a market.
- With Merritt and Amila, met at EP BiH with GD Kreso and Aganovic. On the subject of supply of electricity to Aluminij, Kreso and the EP are under new pressure from Dreski and the Prime Minister. Aluminij sent a letter to the PM requesting that a commission be set up to examine the EP's books because of alleged illegal sales of electricity that contravened the OHR Law of last

December. No proof of any wrongdoing was offered. The PM then sent a letter to MoE Zigic to look into this matter. EP BiH has responded with actual sales and exchanges of electricity for the first two quarters, which show that the only sales are to the two contracts that they had signed last year. The net of all exchanges that they have made as a result of the operations of ZEKC has been a net purchase of electricity during the six months.

Kreso said that they need to put pressure on the MoE and on FERC to implement the new Tariff System and new tariff rates, particularly new inter-company tariffs. If this is not done, EP BiH will lose money next year in supplying electricity to Aluminij. Kreso said that he would be criminal if he allowed this to happen, and that rather than sell at a loss, he would shut down some generating units.

With regard to the discussions with EP RS on supplying back-up power so that EP RS could bid firm power to EP HZHB, Kreso said that they are overhauling a 230 MW unit at Kakanj and are unable to supply the needed back up during August.

Kreso complained that the EP is unable to put pressure on debtors who owe the EP about 100 million KM because the Prime Minister won't allow them to disconnect or to initiate court actions against the debtors.

- With Merritt, Peter, Heather and Amila, met with RS Prime Minister Mikerevic to discuss a number of items including some that were supplied by EP RS GD Dakic. The first item of discussion was the concessions that the RS Government is considering for Buk Bijela and the Vrbas River HPPs. We said that we are very concerned that the concession documents contain terms and conditions that would put the RS Government and the EP at great liabilities unless they were changed. Mikerevic said that the bidders on these concessions cannot depend on the RS Government or the EP to assume any liabilities. He requested that we continue to act as advisors on these concessions to assure that this is not the case. Merritt said that we would continue to advise.

On the subject of interference by the Government on the GD's ability to appoint senior management of the EP, the PM said that he has not intervened in any appointment except that he requested that the Deputy GD and Finance Director be replaced. However, the SDS would not allow this, and he suspects that the SDS is interfering with other management changes as well.

Mikerevic brought up the situation with the oil refinery that owes a debt of 8 million KM to Zagreb. He is proposing to settle this debt by supplying electricity to Croatia at a price of 29.2 euro/MWh and then the refinery would compensate the EP by giving them products. This sounds like a lose situation for the EP, and we need to look into it further.

We told the PM about the laws that the EP has requested to be amended so that its future operation and unbundling can be accomplished without undue penalties that would be imposed by existing forms of these laws. These include the Laws on Bankruptcy, Expropriation and Enterprise.

With regard to the legal, economic and political mess of Ugljevik II, Mikerevic requested that we examine the numbers of both Ugljevik I and II. He wants to resolve the problems with Ugljevik II because they plan to build Unit 2, rather than eliminate it.

The newly appointed Minister of Energy is Boris Gaspar, formerly Deputy Prime Minister and Minister of Trade and Tourism.

- With Merritt and Bob Archer attended the Donors Conference convened by the EC in Vienna. It was chaired by Brenden Devlin of EC DG TREN, who opened the meeting by stating that the EC does not get involved in detailed design matters within a country; and therefore they propose and support the simplest systems in member or prospective member countries. Some of the significant notes from the meeting are:
 - CIDA will extend SEETEC's contract for an additional \$5 million, plus providing an advisor to MOFTER for the new Energy Department. They will not provide an acting head of the department, but an advisor to this position.
 - DFID has reactivated the contract for KEMA, but has made some cuts to the SOW.
 - After considerable discussion on the BiH national market, it was agreed that the initial market should be considered a transitional one that would be a regulated bilateral contracts market with a simple balancing mechanism. There is still disagreement between Barbeau of SEETEC and PA Consulting on the method of payments for this balancing system. Both will prepare a discussion paper promoting their proposals.
 - The World Bank (Iftikhar) is against moving towards creating a single regulatory commission because it changes the goal posts from our agreement in 2000. Devlin was also cool to the idea, saying that it was not a requirement of the EU, but that we could state that it is the desirable solution.
 - In discussing the large, expensive hydro projects that are being planned, Devlin said that the EC could interfere with a country that is planning to create liabilities that would become a stranded asset. To that end, he requested that we send our discussion papers on these projects to the donors for comment, and then the EC would write such a letter.
 - Devlin also said that the EC DG EX FIN could get involved in promoting privatization of the energy sector because of the financial gains it will bring to the country.
 - In discussing the work on the Single Market Design, the EC reported that plans are being made for a Regional Regulatory Board that will develop minimum requirements for regional traders. The work on the transitional phase of the Regional Energy Market was discussed. It was pointed out that we cannot speak of a Regional System Operator for SEE because

this is an unacceptable term in the EU and it would be vetoed. We must refer to a Regional Trading Center. Devlin said that he has received letters from every country, and in some cases multiple letters from the same country, with proposals for the location of this Center.

- Distributed discussion papers on the RS Government's planned concessions and on the planned projects that EP HZHB is undertaking to the donors for their comments. Both papers show the bad economics of these projects and the liabilities that the EPs and the Government will be undertaking by proceeding with them.
- With Peter and Amila, met the new RS Minister of Energy, Boris Gaspar, in Banja Luka, along with Milovanovic, his advisor and Radovic, the lawyer from the EP RS. We discussed the issues that were on the agenda of the meeting with PM Mikerevic last week. Since Gaspar had only been on this job for a week, he was not cognizant of most of the issues, but said he would come up to speed on them, and then be prepared to address them in a future meeting. The one issue that he had some background was that of the concessions that were being discussed because they had been discussed in Government meetings. With regard to the draft Concession Contract for the Vrbas River HPPs, the MoE has collected all of the comments from the other ministries as well as from us and has prepared a new draft that they requested that we review.

Gaspar said that in the meeting at OHR on 14 July, he had learned that the industrial customers in the RS paid 90% of their electricity tariff as a capacity charge and only 10% for energy. This is a fault of the tariff system in the RS. The MoE has designated a tariff working group to examine the tariff system and recommend necessary changes. He has requested our assistance in this effort.

Radovic informed that the Government has appointed a committee last week to look into the liabilities of Gacko, Ugljevik I and Ugljevik II. This must have occurred after our meeting with Mikerevic.

- With Merritt, Bob Archer and Amila, met with EP BiH DG Kreso and Emir Aganovic. They reported on the meeting at OHR on 14 July that Hayes called with the Entity MoEs and the three EP GDs. Kreso said that he was satisfied with the meeting because OHR is finally addressing the issues that need to be addressed to make a unified Federation market work properly. Hayes said that on 16 August he will establish FERC, and that the Federation Action Plan will be completed by the end of August. Merritt countered both of these statements with an update to the progress (or lack thereof) on these efforts. Merritt reported on a discussion with Dreski in Vienna on 15 July where Dreski said that the Federation market would be integrated by the end of 2004. Merritt responded that this is not something that can be legislated, but that for this to happen, we need to have a comprehensive tariff system in place as well as an operational FERC.

Merritt reported on the lack of progress in getting the Action Plan through the Parliament, and suggested that it may be October or November before this process is completed, and even then, we don't know what amendments the House of Peoples may add. Kreso said that maybe OHR is planning to impose

the Action Plan; but Merritt said that the EC is against imposition of any of the 16 items on the Athens MoU.

Kreso said that the EP has prepared detailed information to support their request for tariff changes to correct the improper inter-company tariff situation that now causes EP BiH to lose money on every trade that they would make in 2005 under the present system. He requested that I work with Aganovic to understand all of their analyses so that we can support their position with the Ministry. He also discussed the situation in the coalmines that support the two TPPs, and said that the Coal Mine Action Plan that the Government just adopted would make the situation in the mines more unfavorable to the EP. We agreed that this is a problem, and that it will have to be worked out when we harmonize the Coal Mine Action Plan with the Electricity Restructuring Action Plan.

- Met with Emir Aganovic at EP BiH to discuss the analysis that will support the tariff proposals for the interim inter-company tariffs that need to be agreed during the next two months. The EP has developed detailed costs for all of their generating plants, so they know what the costs of production are, depending on the coal costs. They will have the estimates for 2005 completed in two weeks. The average cost of production should be the same for all customers.

There are two additional proposals in the draft of the new Tariff System that are a problem. The first is that they have reduced the peak season from six months to four months. It should remain at six months. The second problem is that they have proposed that all 24 hours of Saturday be at the low daily rate, whereas before only Sunday was at this low daily rate. There is no justification in either of these reductions because the loss of revenue is not recovered any other place. In fact, for large customers with a fixed annual load, there is no reason to have variable tariffs for different times of the year.

- Met at USAID to discuss the upcoming meetings with Minister Doko and with Don Hayes. The main purpose of the Doko meeting is to get his support on forming a Working Group to address the needs of the Athens Treaty requirements that are coming up during the next couple of months. In the meeting with Hayes, we want to discuss the Vienna donors' meeting, the status of the Action Plan, the concessions that are being planned by the RS and EP HZHB, the new Tariff System that is required to remove cross subsidies and provide for full cost coverage and how the efforts of OHR are working against that effort, and the unified State Regulator.
- With Jane, Lejla, Merritt and Bob Archer, met with Minister Doko, Reuf, and Mrs. Bocicic, a new appointee to the new Department of Energy. We were informed that two employees have been hired and that there are still three vacancies in the Department plus the head of the Department. The plan is to fill these vacancies by shifting people from the Entity Governments. They have no equipment and no budget. Merritt said he would look into USAID, storeroom to see if they have any equipment that could serve in the near term.

We requested that Reuf and the existing employees get involved immediately in providing the responses that are required by the Treaty schedule that need answers by the end of August. We then learned that Reuf will be gone for three

weeks, Bocicic for two and Doko for an undetermined length of time. Jane worked out a schedule for them to be able to respond to the Treaty requirements that requires the implementation of a WG this week. The situation is pretty much status quo, with no resources in MOFTER and none likely in the future.

- With Merritt, Bob Archer, Pat Jacobs and Jane, met Don Hayes and Lejla at OHR. Merritt stressed the importance in lobbying to get the Federation Action Plan successfully through Parliament by September. Hayes said that he didn't think that he can help because the HDZ has decided that it will oppose every move towards reform. He asked if on the condition that it would be imposed by OHR, would it be able to be implemented without getting rid of Maric. We responded that this would be the responsibility of the Government, but suppose that this would have to happen. Hayes said that OHR would not impose it under that condition. He said that he is willing to try to influence the HDZ and that he will have Ashdown do the same, and that Ambassador Bond should also lobby the key HDZ guys (only the Ambassador will be effective from the U.S. Embassy).

Archer gave a synopsis of the donors' meeting in Vienna, with emphasis on achieving cost-based tariffs, a single independent regulator and the problems with the new projects that are being considered by the EPs. After a tirade against EP BiH for obstructing in the Aluminij situation, he said that he supports the creation of a single tariff methodology, and would call a meeting to put pressure on the two Entity Ministers of Energy to work to achieve this for implementation in 2005. We told him this would have to be completed by the end of September, and he said that he would call this meeting next week. On the issues of the single regulator and the problems caused by the planned new hydro projects, he said that he supported our position completely.

- With Amila, met with Mr. Dabovic of EP RS to discuss the negotiations concerning the latest tender to sell excess electricity during the second half of 2004. The winning bidders were EP HZHB, Montmontaza and Petro Carbon and Chemical (PPC). This latter one is a trader who says that have worked with Sempra in the past. [The contact person is a Mr. Goldmann, a German. Do we know him?] They bid to purchase electricity in either Zone 1 or 2, but are now negotiating for purchase in Zone 1. This causes EP RS a problem because the other two winning bidders are also purchasing in Zone 1. Until the new 450 KV line between Gatcko and Mostar is completed, all electricity purchased in Zone 1 must be transferred through the two 210 KV lines that run in parallel through Herzegovina, and they are subject to weather and are not reliable. Both of these lines went out due to a storm over the weekend, and they had to shutdown Gatcko and cut load to two major customers (EP HZHB and Montmontaza).

During the high water season this spring when they had more electricity than they could sell, they "stored" some electricity with Serbia and Montenegro and with Macedonia. Their agreement is that this stored electricity will be returned in kind at some future date (as yet unspecified). This action was justified on the basis that if it had not occurred the water would have been spilled and they would have achieved no benefit. This might be the case, but it was unmonitored at the time.

Dabovic will be consolidating all of the information from the daughter companies into a projected balance for 2005 during the next month. He plans to have a draft of this by the first of September. He expects that they will have a surplus over domestic demand of between 1100 and 1400 GWh. I emphasized the importance of meeting this date so that they could tender this during the month of September for next year.

- With Merritt and Amila, met with Minister Zigic, and part time with his assistant Srdjanovic. Merritt reported on the efforts of the US Embassy to lobby the Federation Parliament on passage of the Action Plan, where the HDZ is not being cooperative. Ambassador will meet with them prior to his leaving. Merritt told Zigic that USAID is going to support integrating the Coal Action Plan with that for electricity, the development of a social plan and implementing gas reform. Zigic said that the Coal AP, which is a combination of the WB and the German studies, will be translated and sent to us shortly.

We then discussed the changes that we have recommended to the draft of the new Tariff System, primarily in the three following three areas:

- There should be no discounts given because there are no corresponding increases to make up for the lost revenue; and if this were done as in the old tariff system, it would result in cross subsidies.
- There is no reason to reduce the winter season to three months and it should remain at six months. For large customers with a constant load, there is no reason to have seasonal rates, and they should have a single annual rate as is done in Europe. If Saturday is to be made a low-rate day like Sunday, then the rates should be adjusted so that there is not a loss of revenue.
- The Inter-company Tariff calculation must be changed to make the average cost of producing/acquiring electricity comparable for the two EPs. We proposed a method for determining this inter-company tariff and sent a description of this methodology with case studies showing how it works to Zigic.

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Issues

- The most optimistic scenario for approval of the Federation Action Plan will result in a three-month delay.
- The new law governing the market in the Federation means that the tariffs must be changed by end of September so that the tariffs will cover the costs of production by EP BiH for sales to large industrial customers such as Aluminij, and also so that the newly proposed Tariff System, with necessary amendments, replaces the old Tariff System

- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- After our recommendation were made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government, they removed the offending documents from the required bid documents so that they are now not subject to public scrutiny
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated with the other EPs
- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bileca
- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field
- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them
- We are attempting to have the RS Government request that the RS Law on Public Enterprises be amended to reduce the supermajority from 75% to a simple majority required for changes in the structure of public companies so the restructuring of the EP cannot be blocked.
- The Federation House of Representatives has voted to limit the amount of the electric companies that can be privatized to 49%.
- The Federation Government adopted the Coal Mine Action Plan that is based on the German Study on the Rehabilitation of the Coal Mines, which is in contradiction of the recommendations that were made in the Electricity Action Plan.

USAID MOBIS CONTRACT No. GS-10F-0014K

INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR

MONTHLY STATUS REPORT – AUGUST 2004

PA GOVERNMENT SERVICES, INC.

Activities

- **Republic of Srpska**

Due to the OHR's dismissal of RS officials, Minister Bogicevic (Minister for Energy, Economy and Development) was replaced. As his successor Mr. Dorde Lajsic, former Privatization Minister in Serbia and Montenegro was appointed. Merritt Broady met with the newly appointed Minister in Banja Luka to discuss with him efforts that are carried out in the energy sector. PA Consulting prepared talking points for Mr. Broady for this meeting. Mr. Broady informed us that the new Minister welcomes reform in the energy sector and offers his assistance in future activities. The RS Government and EP RS Management are showing more willingness to cooperate, which certainly improved our relations as well as level of success in restructuring endeavors.

- **Federation of Bosnia and Herzegovina**

1. Article 85 of the FBiH Law on Electricity is amended differently by the two Houses of Parliament and now is a subject for harmonization in the FBiH Harmonization Committee. FBiH House of Representatives approved a version of Article 85 which mandates that FBiH Action Plan for Restructuring and Privatization (further FBiH Action Plan) – Part I be subject to approval by FBiH Government, where Part II which addresses Privatization shall be approved by both Houses of FBiH Parliament. On the other hand, FBiH House of Peoples approved a version of Article 85 which was also initially proposed by the FBiH Government that states that the FBiH Action Plan in its entirety be subject for approval by both Houses. The FBiH Harmonization Committee, tasked to give a proposal to both Houses to accept one or the other version of amended Article 85, thus far was unable to reach an agreement. OHR showed significant interest in terms of lobbying efforts to convince the FBiH Harmonization Committee to pass and propose for further adoption the version of Article 85 proclaimed initially by the House of Representatives. The FBiH Harmonization Committee requested an official position from the FBiH Government in regard to this issue, and OHR with assistance from PA Consulting sent a letter to the FBiH Ministry for Energy, Mining and Industry to assist them with a list of arguments that can be provided to the Committee in advocating for the version of Article 85 approved by the HoR. Since no further action will be taken before the elections, this inaction is causing an additional significant delay in obtaining approval of the Action Plan.

2. The FBiH Ministry for Energy, Mining and Industry appointed an expert group composed of representatives of FBiH Ministry, both Federation EPs and two large consumers (Aluminiji Mostar and BiH Steel) to draft a new Tariff System for sale of Electric Power in the Federation of Bosnia and Herzegovina. An expert group completed its work and submitted to PA Consulting a draft of the new Tariff System for review and comments. We made number of changes on the proposed draft and returned it to the Ministry with a proposal that this modified draft of the Tariff System be treated as Ministry's version. Minister Zigic agreed with this tactic and the new draft was forwarded to the EPs for review. Two major changes were proposed by PA Consulting - elimination of discounted prices and the introduction of a method to determine tariffs for inter-company delivery during the interim period.

USAID representatives and PA Consulting were present at the meetings called by the FBiH Ministry where new draft was discussed. Initially, EP HZ HB opposed the new version of the Tariff System. They insisted that portions of the old original draft of the document (version from the expert groups) which defines and regulates Inter-company delivery be re-inserted and that the high season to low season ratio be changed from 6:6 to 4:6. Other participants agreed to these changes. During the second meeting, Mr. Vlado Maric (GD for EP HZ HB) agreed that the new Tariff System as drafted should be proposed to the FBiH Government for approval with additional provision which mandates that the Government in a near future also proclaims new Tariff Rates. At the end of this meeting it appeared that consensus was reached and the new Tariff System could be proposed to the FBiH Government for final approval. Within days of this meeting, however, Mr. Maric sent an official letter to the Ministry stating that he is against the proposed Tariff System (this position is a complete reversal of what he agreed to during the meeting).

- **Elektroprivreda BiH (EP BiH)**

1. EP BiH management showed its support and carried out some lobby efforts with the FBiH Harmonization Committee to help in passage of Article 85 of the Law on Electric Power as it is proposed by the House of Representatives.
2. EP BiH actively participated in the drafting process of the new Tariff System for the Sale of Electric Power in Federation of Bosnia and Herzegovina.
3. PA Consulting continues to work closely with all counterparts from EP BiH on various segments that pertain to the issues related to the electro-energy sector.

- **Elektroprivreda Republic of Srpska (EP RS)**

1. The EP RS Management Board adopted the Decree on Transformation of EP RS headquarters and daughter companies into JSCs. PA Consulting reviewed the proposed decree and provided its comments several times. The version of the decree that is adopted is fully acceptable for PA Consulting.

2. We reviewed the proposed Tariff System for Sale of Electric Power in Republic of Srpska. Comments are not significant yet certain changes need to be made. The new RS Tariff System will have to be negotiated with the RS expert team that drafted it in order to harmonize it with proposed FBiH Tariff System, since OHR requested full harmonization of two systems. A major difference between the two proposed systems is that RS proposes seasonal ratio 6:6 where FBiH agreed on 4:6.
3. EP RS Financial Department delivered their methodology for write-off of aged debt which we reviewed. Their method is not in line with international best practice. This is planned to be one of the subjects for discussion with Mr. Pantelija Dakic (GD of EP RS) in the near future.
4. The efforts of PA in participating in the bid review committee for the tender for the new Project Power Plant Buk Bijela Srbinje is discussed in the separate memo, "Buk Bijela tender commission technical bid evaluation Sept.8th 2004".
5. PA provided comments to the final version of draft Concession Agreement for the Power Plants Banja Luka –lower and Krupa and these comments were forwarded to Mr. Milovanovic (tasked by RS Ministry to oversee implementation of negotiation efforts with the winning bidder). The latest version of the Concession Agreement continues to include provisions that transfer all liabilities caused by the project onto EP RS and the RS Government, and this continues to present a significant problem.

- **Elektroprivreda Croatian Community Herceg Bosna (EP HZ HB)**

EP HZ HB continues to obstruct all efforts that are being made in the process of reform of electro-energy sector in FBiH.

Actions

- Passage of Article 85 as proposed by the House of Representatives as soon as possible.
- Passage and implementation of FBiH Action Plan for Restructuring and Privatization of Energy Sector in BiH – Part – I Restructuring.
- Passage of the new FBiH Tariff System for Sale of Electric Power in Federation of Bosnia and Herzegovina by 30 September
- Passage of the new RS Tariff System for Sale of Electric Power in Republic of Srpska by 30 September.
- Continue to oversee process of technical evaluation of international tender for Project Buk Bijela.

Issues

- The most optimistic scenario for approval of the Federation Action Plan will result in a further three-month delay.
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP
- After our recommendation was made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government, they removed the offending documents from the required bid documents so that they are now not subject to public scrutiny
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated with the other EPs
- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bileca
- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field
- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them
- We are attempting to have the RS Government request that the RS Law on Public Enterprises be amended to reduce the supermajority from 75% to a simple majority required for changes in the structure of public companies so the restructuring of the EP cannot be blocked.
- The Federation House of Representatives has voted to limit the amount of the electric companies that can be privatized to 49%.
- The Federation Government adopted the Coal Mine Action Plan that is based on the German Study on the Rehabilitation of the Coal Mines, which is in contradiction of the recommendations that were made in the Electricity Action Plan.

USAID MOBIS CONTRACT No. GS-10F-0014K
INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR
MONTHLY STATUS REPORT – SEPTEMBER 2004
PA GOVERNMENT SERVICES, INC.

Activities

- With Peter, Amila, Herbert and Selma from OHR, met with Federation Minister of Energy Zigic and his assistant Sadanovic to discuss the activities in the Parliament Harmonization Committee with regard to Article 85 of the Federation Electricity Law. Zigic reported that the Committee has asked him for an explanation of the Government's reason in changing from their original recommendation of the House of Peoples version to the House of Representatives version. Herbert requested that Zigic make a strong statement in favor of the latter version. Zigic said that he has instructed the Ministry to prepare such a recommendation, and that he told Hayes this. Herbert said that OHR would send him a paper with talking points in support of this. With regard to the repeated attempts of EP HBHZ to block the approval of the Action Plan, Zigic stated that this is the Government's plan, not the EP's plan.
- With Peter and Amila, met at OHR with Hayes, MoE representatives and Maric, Kreso and Aganovic to discuss any problems EP HZHB has with the Action Plan. Hayes started the meeting stating why the Action Plan is important: The Athens MoU requires the reform of the electricity sector that is embodied in the Plan; large industrial companies who are potential investors in BiH need a reformed electricity sector so their operations will be profitable, and this won't happen without reform; and Both Entity Governments have signed formal Policy Statements stating that they will perform these reforms.

When asked what problems he has with the Action Plan, Maric said that he has only one problem, and that is that the Federation Plan is not harmonized with that of the RS. I refuted that point, so Hayes asked Maric to say what parts are not in harmony. He said that he did not believe that EP RS is serious about reform and restructuring and doubted that EP RS is following the Action Plan. He said that the treatment of Capljina is different from the hydro plants in the RS and therefore will be at a disadvantage. I disputed that statement and said that Capljina is being treated in the same way as Bococ hydro on the Vrbas River.

Hayes said that if this is Maric's only problem with the Action Plan, then he requests that the three EPs meet and discuss any potential disagreements, so that all can agree that the restructuring as stated in the two Action Plans is truly in harmony. He said that trust must be developed among the EPs if the reform efforts are to be successful. At the end of this meeting, he instructed that all three EP GDs sign a letter that they are in agreement with the Action Plans.

Kreso said that EP BiH believes that the Government, as owners of the EPs, has the right to change the organization of the electricity sector, and that EP BiH is proceeding with the Action Plan as it is written. He said that he will participate in a meeting with the other two EPs, but doesn't want to waste time on reviewing and discussing things for which there was agreement in the past.

Maric then stated that EP HZHB is also unhappy with the proposed restructuring of the distribution companies because it move all of the Herzegovina companies to Sarajevo. Hayes responded that he is not interested in any political arguments, and will not consider them.

Hayes asked about the status of the tariff work that is ongoing to create a new tariff system. Kreso said that this work is on schedule to meet the required date of 30 September. Maric said that this schedule is too short, that the MoE should not be responsible for tariffs and that the old tariff system should be continued for next year. Hayes dismissed these comments by Maric and said that the two new tariff systems should be harmonized by this date.

- With Peter, Herbert and Selma from OHR, Sadanovic from MoE and Aganovic, met with the Harmonization Committee of the Parliament to discuss the solutions to Article 85 of the Electricity Law. The Committee did not have a quorum so it could take no action. The Chairman said that when the Committee cannot reach a consensus, the Government would have to give its opinion. Mr. Boris, the HDZ member from the House of Peoples gave a long condemnation of the Action Plan and complained about USAID and its consultant because they had not been reasonable in addressing EP HZHB's concerns.
- With Amila met with GD Dakic of EP RS. He told us that he is planning to move the HQ of EP RS to Banja Luka. This will be done in stages so that the impact on Trebinje and the employees will be gradual. The first groups to be moved will be his immediate advisors, most of who already live outside of Trebinje, and the Financial Group. The HQ staff that will probably stay in Trebinje will be the hydro generation management, the power planning group (for sales of electricity) and the dispatch group.

We then asked him about the information that Mijatovic had given SEETEC about purchasing a large building in Banja Luka, part of which would be for the HQ of Transco, Dakic said that he didn't believe that a purchase had been made, but that he didn't know the details. He said that Mijatovic had asked him for two million KM for this purpose, but he told him he didn't have it. I reminded Dakic of the problems associated with the EP getting into the real estate business because any liabilities incurred by Mijatovic now will be liabilities of EP RS. If a building larger than is required for the Transco HQ is purchased, the other EPs will not be interested in paying the difference, and the regulator will not allow extra costs to be covered by the tariff. He said that he will look into the details of this. We had a long list of items for discussion, but he had to leave, and agreed to meet again next week when he is in Sarajevo for a Management Board meeting.

- Met with Alain, Alex and Stephane of SEETEC to discuss the transition market and the Market Rules. After much discussion about the details of the transition

market that is proposed in the Action Plans and was further detailed by me in Vienna and by the EPs in our last meeting, SEETEC agreed that they would work with us and with the Regulators to produce transition rules for the transition market to amend to the Market Rule that they have written which can only apply to a fully developed regional market. This is a big step from their previous positions on this subject.

During a follow-up meeting without Alain, the attitude of Stephane changed, and he was back to his previous position that he did not know how to write market rules for a transition market that is a regulated market and is not a market at all because it has no competition. He said that without a model, he did not know where to start. [I expect that is more true than not, because he has copied his previous Market Rules from Nordpool. He may not be able to create an original set of rules to govern even our very simple model. If that is the case, then we can chalk up another "win" for SEETEC.]

- With Peter and Amila, met with Zigic and his staff who worked as part of the Expert Tariff Group along with Kreso and Maric and their tariff experts. We began by listening to many arguments from Maric and his staff as to why we needed to have a new tariff system and why that new tariff system must have an inter-company tariff. Sadonovic from MoE said that in the previous meeting on this subject all of the existing participants had agreed on the draft of the new Tariff System, and so there should be no discussion towards changing this draft. Maric said that the proposed inter-company tariff will cause EP HZHB to lose many millions of KM. Kreso said that EP HZHB cannot continue to force the coal miners to operate at a loss, and that EP BiH must cover their cost of operations. He said that EP BiH had lowered its price twice during the negotiations and that the proposed tariff, to which Maric agreed in the previous meeting, will only cover marginal costs, not total costs.

When Maric still argued against any penalty to EP HZHB from the new tariff system, I told him that for the past three years he has sold his cheap hydro electricity to his highest paying customers, and has forced his lower paying customers to pay the higher cost of imported power. I said that the new tariff system will correct this unfair advantage and will force all consumers to pay the average cost of all generation, the practice under which the other two EPs in BiH operate. Good regulation required that the same rules must be applied to all regulated companies, and that has not been the case in the past. Maric said that if they cannot operate at a profit in this situation, then the tariff rates should be increased so that they will not operate at a loss. He said that new tariff rates must be introduced at the same time as the new Tariff System.

In the end, Zigic said that he believes that the existing draft of the new Tariff System was agreed and should stand. He said that the EPs and the tariff experts at the MoE have seven days to present the new tariff rates that they will propose. At that time, he will introduce the recommendations to the Government for their approval. He committed to make the schedule of 30 September.

- With Peter, attended the IC Donors' Meeting, which was attended by all of the active donors and their consultants. The new Independent Member of the Transco Board, Brian Wemby, who had just arrived, was in attendance. CIDA

announced that they have a candidate for the advisor to the State Department of Energy, who is expected to accept the job. KEMA announced that BiH is now totally synchronized into Region 1 of UCTE, and it will become official on 11 October. To the dismay and consternation of the rest of the attendees, Alain Godeau commandeered one and a half hours of this two-hour meeting describing in detail SEETEC's project of providing TA to Transco. Godeau also said that SEETEC plans to provide TA to the ISO to do their business plan and for their tariff, although he said that they had no money to do this. He asked if any of the other donors could fund this work. Peter said that USAID had proposed in Vienna that they could undertake this TA support to the ISO. EBRD requested that his item be resolved soon because it is concerned about the ISO's liabilities to the Bank for SCADA.

- With Merritt and Howard, met with Patricia Nelson-Duvalles and Emilia Puma of SEED and Marilyn Schmidt to discuss the restructuring and our other work in the electricity sector.
- With Peter, Amila and Herbert of OHR, met in Mostar with the three EP General Directors at the request of Hayes to try to get agreement on the Action Plans of the two Entities. We had provided a statement that Hayes had requested that all three EP GD's sign which stated that they support the Action Plans that have been approved by the respective Governments. Dakic and Kreso stated that they do agree with the Action Plans as approved by their Governments, and that they would sign this document. Kreso said that he would have written a different plan if he were doing it, but that the Government has a different point of view that the EPs and the Government is the owner of the EPs and he believes that the Government has reached a balance with the final Action Plan, so he supports it. Maric said it was about time that OHR convened a meeting of the three EPs to discuss the Action Plans, and that this meeting should have occurred one and a half years ago. He then went through his usual list of objections and offered a new proposal from those he has offered in the past. He said that there is no need to create JSCs, but that we should just create profit centers of the parent company until privatization occurs.

All three GDs described in general their efforts in restructuring and in meeting the objectives of the Action Plans. Maric stated that even though the Federation Plan is illegal, EP HZHB is proceeding with the restructuring and in fact is ahead of the other two EPs in implementing the recommendations of the Plan. However, the schedule that he submitted to support this statement did not agree with the statement, and showed that in most areas they are behind.

Maric said that he could not sign the statement that the other two GDs signed. He acknowledged that if he did not sign it, he might be removed from his position, but he said that if he did sign it, his life might be endangered, so he is considering a third choice. He said that he would sign a separate statement that he would give to the media, and his statement would say that corporatization should be done at the State level (which of course is not possible). The other two GDs said they would not sign such a statement. Kreso and Dakic did sign the statement in support of the Governments' approved Action Plans, and Maric did not.

The following day Maric provided his own statement that he signed which said that he would support an Action Plan if it were approved by the Government and all relevant Parliaments, and if he, as GD of EP HZHB agreed that is met the technical and economic criteria that he deemed best for his EP. The other two GDs did not sign this statement.

- We heard from SEETEC that Elektroprenos EP RS had purchased a facility comprising two buildings in downtown Banja Luka that was to serve as the HQ of the future BiH Transco. SEETEC visited the facility and said that it was much larger than it needed to be to meet the needs of the HQ of BiH Transco during the early years of the new company, and they questioned the authorization of this purchase. Peter, Amila and I met with EP RS Dakic to ask about this purchase. He agree to supply us with documentation that supported the purchase, but said that Elektroprenos EP RS Director Mijatovic had been planning to move the HQ of the new company to downtown, and that he said this should be accomplished sooner rather than waiting for the formation of the company because the latter would cause delays in the schedule for forming the company. He justified the purchase by Elektroprenos by saying that the other EPs would probably pay their pro rata share of the cost of the facility when BiH Transco was formed, but if they did not, the cost could be added to the assets of Elektroprenos EP RS that would be taken into the new company, thus increasing the shareholding of the RS in the new company.

Dakic later provided us with documentation that Mijatovic had provided to justify the decisions that led up to this purchase. We have reviewed this documentation and still have a problem with Mijatovic making a decision to purchase a facility for the future BiH Transco without the agreement of the other two EPs. Also, the oversized facility was very expensive (about twice the average price for commercial real estate in Banja Luka), and so the liability caused by this purchase is about four times what BiH Transco would have to pay for the amount of space it will require in the first years of its operation. There are also some questions about the procurement procedure that was followed because Mijatovic at the start of the process decided that he wanted to purchase the facility from his good friend, the president of Nova Banja Luka Bank, and in the end did so in spit of it not being the low cost bidder to supply a facility. We informed Dakic that the appearance of irregularities would be reported to OHR for their review.

With Amila met with Dragan Andelic of EP RS to discuss several of his concerns with HPP Trebinje and with his role as Board Member of ZEK and a member of the EP Market Working Group. Since the Director of HPP Trebinje had been suspended by OHR, a young engineer has been Acting Director. This young man is not very experienced at this time, but is doing a good job and should be encouraged to stay on with Andelic as his mentor to grow into the job. The problem is that he is very attractive to the SDS and they are running him as candidate for mayor of Trebinje. If he wins the election, he will be lost to the EP. As is the case with most of the daughter companies in EP RS, there are not enough young people being trained to be the managers of the future, and there is no obvious candidate to step in as the new Director. Pressure is being placed on Andelic to take this job, but he desperately does not want it. He sees his job as mentoring a bright young person to grow into the job as he has been doing with the existing incumbent.

Andelic said that even though the restructuring is proceeding at the top level, not enough is happening in the daughter companies. Part of the problem is that most of the directors don't know how to proceed and there is not adequate direction from headquarters. The result is that plans for rationalization of excess staff are delayed and there is no general direction in the EP as to how this will be accomplished. For example, his HPP has 700 people (in two separate HPPs). One hundred of these will go to the BiH Transco, and of the remaining, 300 should be made redundant. Also, plans must be made for the spin-off of non-core businesses that will take some of the existing qualified people who must be replaced. Then to fill the requirement for qualified people to run the independent HPP JSC, 100 new, young, specialized people need to be hired. There is no centralized human resources function in the EP HQ nor in the daughter companies, so there is no direction to these efforts.

He is concerned that ZEKC is not receiving adequate assistance in preparing for the new integrated market that needs to be implemented next year. I agreed that this is an area of concern, and that we need to convene the Market Working Group with ZEKC to discuss what needs to be done and who will do it. He will discuss with Hadzic to have a meeting next week.

- Discussed with Aganovic of EP BiH the new tariff work that the two Federation EPs were scheduled to have completed for Minister Zigic that would propose new rates for each customer class to go along with the new Tariff System that Zigic approved for adoption. Emir said that in spite of Zigic's statement that the latest draft of the new Interim Tariff System would be adopted without further discussion, EP HZHB came back with a new proposal for the determination of inter-company tariffs. My recommendation was to take Zigic at his word and to ignore such a request from EP HZHB. Zigic later confirmed that to be the case. Zigic also said that all tariff rates would remain unchanged at this time with the exception of the rate for high voltage customers, which he would recommend be raised by about 7% rather than the 15% recommended by the WG.
- Met with John Gower of Corporate Solutions, a member of the KEMA team that is advising ZEKC. CS is advising on the organization of the new ISO, and he was interested in the transition market and the requirements compared to those stated in the existing draft of the Grid Code. I discussed how we are planning the market during the transition phases, and responded to his questions about the summary paper that I had prepared for the Donors Meeting. He agrees that the existing market plans must be included in a modified and much simplified version of a grid code that will describe the technical performance of the System during the transition phases.
- With Merritt, Peter and Amila, met with Dusan Mijatovic and Radmilla Cvejancovic from Elektroprenos EP RS at their request. Mijatovic had heard about our meeting with Dakic to discuss the purchase of the building, but did not know the details of our discussion, and was interested to know if we have a problem with it. Merritt told them that our concern was that such a purchase should be the responsibility of the Management Board of the BiH Transco, not of Elektroprenos EP RS, because if the new Management Board or the new shareholders would not agree that this was a prudent purchase, then EP RS might end up owning this asset. Mijatovic went through a long justification of the actions taken, and at

the end agreed that if the other Federation shareholder did not agree to either purchase their share of the facility or to accept that this facility could be brought into BiH Transco, the EP RS would have the liability. They were concerned that we had a problem with the procurement process itself, but Merritt told them that we are not auditors, so it was not our job to evaluate this.

- Met with Paul Brennan, legal consultant of IPA, and Vanja Munerati of IPA. IPA Energy Consulting are advising on the legal issues in the formation of Transco and ISO. We had a general discussion of the TA for Transco and the ISO, and how we view the problems in the formation of these companies.
- Met with Omer Hadzic of ZEKZ to discuss the future work of ZEKZ, the TA that will be needed after the DFID contract is finished, and how to coordinate the work of market requirements with the newly synchronized system. Omer is very supportive of having USAID provide the TA for the transition period during the next one-to-two years as the ISO gets formed and as we introduce the new transitional market.
- With Amila, met the Mr. Zerkovic of EP RS who has been working on the new RS Tariff System. I had made some comments on the first draft and we discussed them and other aspects of their proposal, in particular where it is in disagreement with the new Federation Tariff System that has just been approved by the Federation Minister of Energy, Mining and Industry. There are two issues that are problems with the RS tariffs. One is that because of unreasonably high depreciation rates used by EP RS, the cost structure that is used to make up the tariffs is badly distorted. The EP uses an average depreciation rate of 40% as opposed to an expected value of about 20%. This causes the fixed portion of the costs that go into the tariff calculation to be grossly overstated, and this causes the problems that the industrial customers have complained about. The complaint is justified. These depreciation rates should be revised. Some of the same problems exist in the Federation EPs, and they are being corrected.

The other problem with the new RS tariffs is that, instead of reducing cross subsidies as is our objective in the new tariffs systems, the RS has increased cross subsidies for some low voltage customers at the expense of others. They have penalized the high use residential customers (e.g., heating customers) to the benefit of the lowest use customers. The argument is that the low use customers are the poorest and need subsidized. Such social subsidies for the poor may be appropriate, but should not be provided by other customers of the EP, but by some level of the Government.

- Met with Aygen Yayikoglu of EBRD to discuss the requirements of the Bank in assigning the liabilities of the loans from the EPs to the new Transco and ISO. The Bank will require that the proper covenants are agreed and signed off before they will agree to have the new companies formed. This means that the liabilities must be agreed between Transco and the ISO at the same time that all of the other assets and liabilities are settled. We also discussed the continuation of the TA that the ZEKZ will require in the transition to forming the ISO. Aygen is not happy with SEETEC's proposal to provide this TA because Godeau offered to perform these tasks, but later said that they did not have any money, and could only do it if EBRD would provide the funding. Aygen said that he would be very

pleased if USAID could take over these tasks and provide the TA for the ISO. He will be very concerned if this TA is not available because he does not have confidence that the existing management of ZEKC has the capability to successfully manage the transition to the ISO and meet all of the requirements of the Bank in implementing the SCADA project.

Issues

- The most optimistic scenario for approval of the Federation Action Plan will result in a three-month delay. EP HZHB continues to object to the Plan and has their allies in the Parliament primed to defeat it.
- The new Interim Tariff System has been approved by the Ministry of Energy, Mining and Industry and will now be sent to the Government for its approval. Since EP HZHB still objects to the inter-company tariff, the HDZ will no doubt try to stop this approval by the Government.
- The new interim tariff system for the RS has some significant problems that will not permit it to be adequately harmonized with that of the Federation.
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel and the Buk Bijela HPP Project
- After our recommendation were made to the RS Government Tender Commission for revisions to the *Buk Bijela Concession Documents* that would limit the liability to the EP and to the RS Government, they removed the offending documents from the required bid documents so that they are now not subject to public scrutiny
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated with the other EPs
- The international dispute between BiH and Croatia over the use of water from the Trebisnjica River and Lake Bileca
- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field have not been continued
- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.

- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them
- We are attempting to have the RS Government request that the RS Law on Public Enterprises be amended to reduce the supermajority from 75% to a simple majority required for changes in the structure of public companies so the restructuring of the EP cannot be blocked.
- The Federation House of Representatives has voted to limit the amount of the electric companies that can be privatized to 49%.
- The Federation Government adopted the Coal Mine Action Plan that is based on the German Study on the Rehabilitation of the Coal Mines, which is in contradiction of the recommendations that were made in the Electricity Action Plan. The Mine Action Plan has to be harmonized with the Electricity Action Plan.
- Elektroprenos EP RS has purchased an expensive facility in downtown Banja Luka to serve as the HQ of the BiH Transco. This should be the responsibility of the BiH Transco Management Board, which has yet to be elected.

USAID MOBIS CONTRACT No. GS-10F-0014K
INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR
MONTHLY STATUS REPORT – OCTOBER 2004
PA GOVERNMENT SERVICES, INC.

Activities

- With Peter and Amila, met with RS Minister of Energy Lajsic and his assistant Milovanovic. We reviewed our list of concerns, in particular the approval by the Government of the contract for the concession of the Vrbas River hydro project, the cross subsidies that the new tariff system contain which will make them hard to harmonize with those of the Federation and the laws that need to be changed to be able to successfully restructure the EP. Lajsic asked if there were any environmental concerns about the proposed hydro projects on the Rivers Vrbas and Drina. We responded that an environmental assessment has not been made in recent times of these projects, and that an EIS should be prepared and submitted to the Governments, including the State Government. Milovanovic then gave an impassioned speech about the RS not being interested in harmonizing their decisions and environmental laws with the Federation because the RS is by law a separate Entity and should not have to have any of its laws or rules overridden by State laws and regulations.

Minister Lajsic then gave us his view of how we would work together in the future. He said that the hydro projects are very important to the RS, and that he understands that we have spent much time in assisting the Government in the evaluation of the contracts. He said that he needs for us to give them some margin to be able to complete these projects because of the good things that they will bring to the RS, including construction jobs, new jobs to run the plants, increased exports and a general increase in the economy. He said that the economics of the projects don't have to be perfect for the EP because of all of these other benefits. It would not matter if they would lose 10 or 15%. Our approval of these projects would be one of the costs of his support on our reforms.

With respect to working on all of the aspects to support the restructuring and the successful completion of the Action Plan, Lajsic said that to do this he needs some help from USAID. He needs to create a team of consultants to assist him in solving all of the problems that now exist and need to be changed. He said that he has the approximately 20 people in mind that he wants to hire to do these tasks, and he needs \$2 million from USAID to finance them. Peter said that USAID could not do that, and he should talk to the EC for that kind of money. However, he would not be deterred, and said that his way of working was to receive something if he is expected to give something, and this was his price. When we added another task that needs addressing, he added another \$200 K to his price.

- Some notable information that came from the World Bank Mission kick-off meeting with Iftikhar:

Reuf reported that MOFTER is late with everything that they are responsible for and gave the usual excuses. He reported that the Energy Department had not appointed a head, and may just move someone from within MOFTER into that spot. They plan to fill this job and add two additional employees by the end of the year, which is when the CIDA-funded advisor is to arrive.

Srdanovic gave a pathetic report of the state of affairs in the Federation MoE. He said the Ministry is woefully understaffed and does not have the capability to respond to the requests that are put to it. With the plan to move the Ministry to Mostar, they are unable to hire people at a time when the formation of the new State level institutions have resulted in more work from the FMoE. He also said that there is not a good working relationship between the MoE, the Government and Parliament. One positive thing that he notes is the recent involvement of OHR in the energy sector. He reported that the new tariff system has been adopted by the Ministry and will be submitted to the Government for its approval.

Milovanovic reported that some of the EP RS daughter companies are not complying with the schedule for corporatization, and may have suits filed against them. All registrations were to be accomplished by 30 June, and some are still not completed. On Buk Bijela, he said that an agreement has been reached between the RS and Serbia/Montenegro on the sharing of the project. He also said that RS and Montenegro have agreed to perform an environmental study to assure that all current regulations are met.

Aganovic reported that the new tariff system that Srdanovic announced that was adopted by the Ministry had been changed overnight, and the new inter-company tariff that was adopted was different from that agreed in the new tariff system the previous week. The final draft of the new Interim Tariff System proposed a formula for the calculation of the inter-company tariff. The formula was set so that EP BiH would sell electricity to EP HZHB at its minimum marginal cost to generate, so that EP BiH would not lose money (or make a profit) when selling inter-company. However, when the formula was used to determine the tariff for the coming year, 34.1 KM/MWh, EP HZHB objected to the tariff as being too high and requested a lower tariff, 32.0 in a letter to Begic, assistant to the Minister who was a member of the Tariff Working Group, and who was aware of the agreement on the formula that had been previously agreed by Minister Zigic. Without any consultation with EP BiH, Begic made the decision to agree to a lower tariff than the formula, a value of 32.5. The results of this arbitrary reduction in the inter-company tariff means that EP BiH will sell electricity to EP HZHB at a loss. This goes against the basis for developing the formula, and gives EP BiH no incentive to produce if they have to sell at a loss. In fact, EP BiH stated that they will not have excess electricity to sell at this tariff, which is a very reasonable position for management to take. This would mean that EP HZHB would have to purchase more than 2,000 Gwh on the market at prices higher than those determined by the formula. It would also mean a loss of over 100 million in revenues from within BiH, with the corresponding loss of jobs. This is an inequity that needs immediate attention before the new Tariff System goes to the Government for approval.

Maric reported on the six-month results for EP HZHB. He said that they had a profit of 21 million KM for the six months (they are the only EP that has reported a profit, and yet he insists on purchasing electricity from EP BiH at lower than the cost to produce). He also reported that the new hydro plant Pec Mlini had become operational. He said that they could not proceed with the Action Plan because it was not harmonized with the RS Action Plan in any way, and that the Constitutional Court had ruled that there must be harmonization before the Plans could be approved. Iftikhar reminded Maric that the Court did not rule on the content of the Action Plan, but only on Article 85 of the Electricity Law.

Deputy GD and head of Finance at EP RS gave a short report on the six-month results of his EP, including the fact that they had a loss of 10 million KM for the six months. He said that the restructuring efforts of the EP will be expedited when the new Companies Law is passed, and that should happen soon.

- With Amila, met with ZEKČ and the three EP members of the Market Working Group to discuss the implementation of the new transitional market. Because the BiH system is now fully integrated, system operations will have to change from the three separate dispatch systems that have operated in the past. Starting November 1, BiH will no longer be able to settle imbalances with neighboring systems with energy exchanges, but will have to settle with money. ZEKČ must create an accounting and settlements department who will perform these functions. The expertise for this new organization should come from the EPs because it does not exist in ZEKČ. Sadanovic of EP BiH offered to create a model from which to work and discuss at the next meeting of this group that is scheduled for 20 October.
- Merritt, Peter, Heather and Amila attended a meeting held by the FBiH Ministry to discuss re-drafted version by PA Consulting of FBiH Tariff System. The major change that was introduced in this draft was a different approach in determining the inter-company tariff rate. Even though the meeting lasted for several hours, agreement was reached under the condition that when the new FBiH Tariff System is proclaimed, new Tariff Rates be introduced as well. At that time, it appeared that issue was settled and it was up to the Ministry to make minor non-substantive changes and present the FBiH Government with a Draft of the new Interim Tariff System and Tariff Rates for its approval.
- Merritt and Amila attended a meeting organized by the FBiH Ministry because EP HZ HB opposed agreements that were reached during previous FBiH Ministry's meeting in regard to the new FBiH Tariff System. EP HZ HB during this meeting claimed that they do not agree with the principle under which the inter-company tariff is determined. This is certainly different agreement that they made during the prior meeting on the same issue. EP HZ HB insisted the that new Tariff System be re-drafted so inter-company tariff is determined as it was agreed initially by the expert working group for design of the new Tariff System. Other participants in this meeting (representatives of EP BiH, FBiH Ministry) agreed that this model may be acceptable as well. EP HZ HB also proposed that members of expert working group meet again in order to determine exactly what would be the value of the marginal cost (since this item in part determines the potential inter-company tariff rate) and again all other participants agreed to this approach. The conclusion of the meeting was that provisions which regulate

inter-company delivery as described in initial draft created by the expert group be re-inserted into the new draft of FBIH Tariff System and that the WG meets again in order to discuss determination of marginal costs.

- Amila attended a meeting scheduled by ZEKC to discuss market rules for the transitional period. The Working Group submitted a report that explains in detail issues that were discussed during this meeting. In short, this meeting was purely informational, with the current situation being described with some potential solutions for the future design offered by the representatives from EP BiH. At the end of the meeting it was concluded that WG for Creation of Transitional Market Rules will have to meet again as soon as possible where each EP along with ZEKC will give actual proposal for design of future transitional market.

Issues

- The most optimistic scenario for approval of the Federation Action Plan will result in a three-month delay. EP HZHB continues to object to the Plan and has their allies in the Parliament primed to defeat it.
- The new Interim Tariff System has been approved by the Ministry of Energy, Mining and Industry and will now be sent to the Government for its approval. Since EP HZHB still objects to the inter-company tariff, the HDZ will no doubt try to stop this approval by the Government.
- Federation Regulatory Commission for electric power is exposed to significant pressure by the FBIH Ministry for Energy, Mining and Industry and FBIH Government to approve proposed FBIH Tariff System and Tariff Rates.
- The new interim tariff system for the RS has some significant problems that will not permit it to be adequately harmonized with that of the Federation.
- Active plans of EP RS to continue construction of the Fatnicko Field Tunnel, the Vrbas River HPPs and the Buk Bijela HPP Project
- After our recommendation were made to the RS Government Tender Commission for revisions to the Buk Bijela Concession Documents that would limit the liability to the EP and to the RS Government, they removed the offending documents from the required bid documents so that they are now not subject to public scrutiny
- Negotiations are ongoing for a concession for two HPPs on the Vrbas River, and the concession documents have been reviewed and they have similar problems to those of Buk Bijela
- The tender for billing and collections software of EP HZHB is not being coordinated with the other EPs
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- Discussions between EP RS and EP HZHB to resolve the water supply to Capljina HPP and the Popovo Field have not been continued
- The RS Bankruptcy Law is geared towards allowing creditors to take over a company with outstanding debt and needs to be changed. This is critical for Gacko now, because there is consideration in the RS Government to letting the company go into bankruptcy.
- The RS Agency for Privatization is attempting to corporatize the EP RS daughter companies before they are restructured, and if that happens, the Government will own less than the 75% required to restructure them
- We are attempting to have the RS Government request that the RS Law on Public Enterprises be amended to reduce the supermajority from 75% to a simple majority required for changes in the structure of public companies so the restructuring of the EP cannot be blocked.
- The Federation House of Representatives has voted to limit the amount of the electric companies that can be privatized to 49%.
- The Federation Government adopted the Coal Mine Action Plan that is based on the German Study on the Rehabilitation of the Coal Mines, which is in contradiction of the recommendations that were made in the Electricity Action Plan. The Mine Action Plan has to be harmonized with the Electricity Action Plan.
- Elektroprenos EP RS has purchased an expensive facility in downtown Banja Luka to serve as the HQ of the BiH Transco. This should be the responsibility of the BiH Transco Management Board, which has yet to be elected.
- Elektroprenos EP RS is constructing a new 400 KV line that will connect Ugljevik directly to Serbia, in spite of a prior decision of the EP not to construct this line.

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INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR
MONTHLY STATUS REPORT – NOVEMBER 2004
PA GOVERNMENT SERVICES, INC.

Activities

- Met with Mile Srdanovic, advisor to Minister Zigic to discuss that status of the new Tariff System. Learned that Zigic and the other two Federation Government ministers from the Party of BiH has walked out of the Government session two weeks ago because of a dispute with the SDA, and he has not been back to the Ministry since. The complete package for the new Tariff System is ready to go to the Government, but Zigic is not here to submit it and it is not on the agenda for the Government's session on 11 November. Srdanovic then spent an hour *complaining about the situation in the MoE where the Minister Zigic doesn't feel strong enough politically to do anything and where he, Srdanovic, has no support or help to carry the work on energy.* He also complained that the new BiH Energy Department has hired several people but request any work on energy to be supplied by the Entity MoEs.

Learned later from Aganovic of EP BiH that Zigic has sent a letter of invitation to the two EPs, the Tariff Working Group and all of the Government Ministries to hear a presentation on the new Tariff System on 16 November. Also learned from Jane that PM Hadzepasic has invited the FERC and SERC Commissioners to a meeting on the same day prior to the Government meeting. It appears that the Government is still trying to obtain greater support from the regulators in imposing the new Tariff System.

- Met with Omer Hadzic and Milorad Tusevljak of ZEK to discuss what technical assistance ZEK and the ISO will require during the formation of the ISO. Such TA would include that not supplied by the DFID project as it was originally proposed plus any other that was not included in the DFID project. They provided me with a list that was prepared jointly by KEMA and ZEK plus another list that was prepared by ZEK management. I have extracted the information and included it in a proposed scope of work for an extension of the existing PA Consulting contract to provide this TA to ZEK/ISO.
- Attended a meeting of the Federation Government where the Ministry of Energy, Mining and Trade presented the new Tariff System. The meeting was called by the Prime Minister and was attended by the Government ministers, the two EPs, the Expert Group who worked on the new Tariff System, SERC and FERC. Srdanovic and Begica from the MoE presented the results of the Expert Group and the reason for introducing this interim tariff system at this time so that the new integrated Federation market could properly operate in 2005. The MoE had also provided for an alternative Inter-company tariff to the one agreed during our

last meeting. Then Hadzipasic asked SERC and FERC why they were not taking responsibility for these new tariffs since this is now their responsibility. SERC responded that they only have responsibility for Transco and ISO tariffs, and that they will introduce their tariff methodology sometime next year. FERC said that they are also working on their tariff methodology and would not be prepared to give an opinion on new tariffs until after this new methodology is completed, also by about mid-2005.

Minister Zigic said that both EPs had agreed to both of the options for the Inter-company tariff that had been presented. He then said that there are two options to proceed to implement the new Interim Tariff System: (1) FERC should give its approval to the Tariff System as presented for implementation in 2005; or (2) he will instruct the two EPs to file to FERC for a rate review so that FERC can determine the tariffs itself, rather than have it done by the MoE. Of course, FERC has already said that they refuse to do the former, and have also said that the latter will not be done until the new rates would be introduced in 2006. The MoE, or the Government, is not willing to risk approving tariffs and, therefore, there is no solution to the tariff rates for 2005, and we have the likely situation that there will be no available electricity from EP BiH to send to EP HZHB for resale to Aluminij.

After the meeting, Maric, GD of EP HZHB, came up to me and greeted me like a long lost brother. This after barely speaking civilly over the past year and a half makes me sure that he has seen or heard about the draft discussion paper for the revised Action Plan. Since this was to be an internal discussion paper between USAID and OHR, its leak could cause a real problem with the other EPs and the Governments. We need to verify the leak and trace it, and start damage control by talking to the other participants immediately.

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INSTITUTIONAL STRENGTHENING IN THE ELECTRICITY SECTOR
MONTHLY STATUS REPORT – DECEMBER 2004
PA GOVERNMENT SERVICES, INC.

Activities

With Amila, met with Dabovic of EP RS to discuss the final energy balance for 2005 that EP RS is to tender to sell. After some discussion with GD Dakic and the advice he saw receiving from his tender commission, Dakic finally accepted the proposal of Dabovic, with which we are in agreement. Because of the unreliability of their own thermal plants, they require back-up reserves in order to offer guaranteed supply. They have reached an agreement with EP Serbia (EPS) to supply some back up, partially through energy exchange and partly through purchase. As a result, they can offer for tender 50 MW for the entire year, either guaranteed or non-guaranteed (they will ask for bids both ways so they can evaluate how the market prices guaranteed supply). They can also offer an additional 50 MW of guaranteed supply for July through December (Quarters 3 and 4), and 100 MW additionally non-guaranteed for Quarters 1, 3 and 4. Bidders will be allowed to bid for unrestricted time periods.

- With Merritt and Amila, met with GD Kreso and Aganovic of EP BiH. The energy balance for 2005 that has been determined by the EP has been approved by the Board. It results in 720 GWh available beyond the EP's own projected customer demand. EP HZHB has issued a tender for 338 GWh for 2005, and EP BiH will bid to supply this at the inter-company tariff that they agreed in the new Interim Tariff System. This will create a problem for EP HZHB because they have a need for 1,000 GWh, and they are counting on the 720 GWh that EP BiH has in excess to fill part of the deficit – therefore, only needing to tender for the difference. EP HZHB is also purchasing 1095 GWh from HEP because their total deficit is 2,100 GWh. When Merritt asked how HEP could offer this when they also operate in a deficit, it is because they are trading. Because there is no agreement on tariffs, and EP HZHB is planning on purchasing EP BiH's excess at tariff rates, we will have a crisis at the end of the month, just as we did last year. Merritt said that he and the Embassy are trying to meet with Hadzipasic, and will tell him that USAID supports EP BiH in not being willing to sell their power at a loss. Kreso said that the Government is the owner of his EP, and if his shareholder told him to do that, he would have to comply.
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- Attended a meeting of the Federation Government where the Ministry of Energy, Mining and Trade presented the new Tariff System. The meeting was called by the Prime Minister and was attended by the Government ministers, the two EPs, the Expert Group who worked on the new Tariff System, SERC and FERC.

Srdanovic and Begica from the MoE presented the results of the Expert Group and the reason for introducing this interim tariff system at this time so that the new integrated Federation market could properly operate in 2005. The MoE had also provided for an alternative Inter-company tariff to the one agreed during our last meeting. Then Hadzipasic asked SERC and FERC why they were not taking responsibility for these new tariffs since this is now their responsibility. SERC responded that they only have responsibility for Transco and ISO tariffs, and that they will introduce their tariff methodology sometime next year. FERC said that they are also working on their tariff methodology and would not be prepared to give an opinion on new tariffs until after this new methodology is completed, also by about mid-2005.

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